

TREASURY DEPARTMENT'S REPORT ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY

HEARING

BEFORE THE

**SUBCOMMITTEE ON INTERNATIONAL FINANCE
AND MONETARY POLICY**

OF THE

**COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE**

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

ON

**THE OUTLOOK FOR INTERNATIONAL COOPERATION TO STRENGTHEN
ECONOMIC GROWTH AND TO REVIEW FINDINGS OF COUNTRIES WHO
MANIPULATE THEIR CURRENCY TO GAIN A COMPETITIVE ADVAN-
TAGE IN INTERNATIONAL TRADE**

MAY 16, 1991

- Printed for the use of the Committee on Banking, Housing, and Urban Affairs



For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-035334-3

5241-51

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

DONALD W. RIEGLE, Jr., Michigan, *Chairman*

ALAN CRANSTON, California
PAUL S. SARBANES, Maryland
CHRISTOPHER J. DODD, Connecticut
ALAN J. DIXON, Illinois
JIM SASSER, Tennessee
TERRY SANFORD, North Carolina
RICHARD C. SHELBY, Alabama
BOB GRAHAM, Florida
TIMOTHY E. WIRTH, Colorado
JOHN F. KERRY, Massachusetts
RICHARD H. BRYAN, Nevada

JAKE GARN, Utah
JOHN HEINZ, Pennsylvania *
ALFONSE M. D'AMATO, New York
PHIL GRAMM, Texas
CHRISTOPHER S. BOND, Missouri
CONNIE MACK, Florida
WILLIAM V. ROTH, Jr., Delaware
PETE V. DOMENICI, New Mexico
NANCY LANDON KASSEBAUM, Kansas

STEVEN B. HARRIS, *Staff Director and Chief Counsel*
LAMAR SMITH, *Republican Staff Director and Chief Economist*
PATRICK A. MULLOY, *Senior Counsel/International Affairs Adviser*

SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY

PAUL S. SARBANES, Maryland, *Chairman*
PHIL GRAMM, Texas, *Ranking Minority Member*
MARTIN J. GRUENBERG, *Staff Director*
JOHN G. WALSH, *Republican Economist*

* Deceased April 4, 1991.

CONTENTS

THURSDAY, MAY 16, 1991

Opening statement of Senator Sarbanes	Page 1
Opening statement of Senator Riegle	52
Opening statement of Senator Dixon	69

WITNESSES

David Mulford, Under Secretary for International Affairs, Department of the Treasury, Washington, DC	3
Prepared statement	7
Response to written questions of Senator Riegle	85
Report to the Congress on International Economic and Exchange Rate Policy, May 1991	12
C. Fred Bergsten, Director, Institute for International Economics, Washington, DC	71
Prepared statement	78

TREASURY DEPARTMENT'S REPORT ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY

THURSDAY, MAY 16, 1991

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FI-
NANCE AND MONETARY POLICY,

Washington, DC.

The committee met at 2:10 p.m., in room SD-538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (chairman of the subcommittee) presiding.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. The committee will come to order. The subject of today's hearing is the report of the Treasury to the Congress on International Economic and Exchange Rate Policy, which was just released by Treasury this morning.

In 1988, when the Congress passed the Omnibus Trade and Competitiveness Act, there was a provision which required the Treasury to submit such a report to the Congress twice a year. This, therefore, is the fourth year in which such reports have been required.

I'd like to take a moment just at the outset to emphasize the importance which the committee attaches to these reports and to the oversight hearing which we're having here today.

Upon their submission, the provision in the 1988 trade bill requiring a semiannual report and testimony by the Treasury on the conduct of international economic and exchange rate policy was, in large part, a response to the experience of the early 1980's, when the dollar was permitted to rise steadily to very high levels for an extended period of time without any effort to bring it into line with other currencies.

The result of this debacle was a deterioration in the U.S. balance of trade, a problem with which we are still struggling today. And I hasten to add it was not the only cause of deterioration, but it may be regarded as a very important cause.

The purpose of the provision contained in the 1988 trade bill was to prevent a repetition of that experience, simply sliding into that state of affairs, by requiring the administration to consult on a regular basis with the Congress on the conduct of this critical area of economic policy.

Initially, the administration was resistant to including this provision in the 1988 trade bill. But, I think that experience has proved

it to be a useful device, to focus both administrative and congressional attention on this important issue; and, of course, to focus on occasion international attention as well.

The report and hearing are timely in light of the recent meeting of the G-7 countries in Washington on April 28, 1991, in conjunction with the interim committee meeting and the IMF Board of Governors. In the communique issued after that meeting, the Ministries noted, and I quote:

The persistence of high real interest rates and the slowing of economic activity in those countries which, until recently, had been experiencing strong expansion.

Against this background, the Ministers and Governors emphasized the importance of monetary and fiscal policies which provide the basis for lower real interest rates and a sustained global economic recovery with price stability.

Unfortunately, the communique had no agreement with respect to the actions to achieve such a goal and, in fact, stated that the Ministers agreed to monitor the situation closely and to take actions as needed within the coordination process with a view to achieving a sound recovery and a growing world economy.

The reports following the meeting indicated that the United States sought to persuade the other countries to engage in a joint effort to lower interest rates as a spur to world economic growth. However, the other member countries, particularly Germany, and apparently Japan, were resistant to such a course of action at this time.

This afternoon, the subcommittee will want to explore the implications of the interim committee meeting and the outlook for international cooperation to strengthen economic growth. In particular, we will want to review the administration's view of the dollar, which appreciated significantly during February and March and has remained at that higher level.

The subcommittee will be interested in knowing what discussions of the dollar took place at the G-7 meeting and what potential the rise in the value of the dollar might have on U.S. exports and on U.S. economic recovery.

In addition, we will want to review the Treasury's findings as required by the trade bill with regard to countries who manipulate their currency to gain a competitive advantage in international trade.

In the past, the focus of these reports and hearings with respect to such practices has been on Taiwan and South Korea. In an oversight hearing held by this subcommittee last year, the subcommittee raised for the first time the issue of currency manipulation by the People's Republic of China.

Last November's report addressed that issue for the first time and found that China was not directly manipulating its exchange rate within the meaning of the legislation because currency devaluation by China had been sporadic and insufficient to offset fully the negative effects of inflation, and because China did not have material global current account surpluses, despite the fact that China was running a very large bilateral trade surplus with the United States.

This morning's report describes some disturbing developments on this particular issue. It states that:

Although there is no clear evidence at this time of direct manipulation of the exchange rate itself within the meaning of the law, it finds that—

And I'm quoting the Treasury's report—

the recent devaluations in conjunction with large external surpluses raise concerns and indicate that a shift in exchange rate policy may be occurring aimed at reinforcing China's attempt to generate sizable external surpluses.

The report indicates that Treasury intends to discuss China's foreign exchange policies with its authorities with a view toward seeing China move toward a more market-oriented exchange rate determination.

The U.S. balance of trade with China has moved from zero in 1985 to a deficit of \$10 billion last year. Since China's global trade surplus last year was \$12 billion, the United States accounted, obviously, for most of China's world surplus.

In addition, it is projected that the U.S. trade deficit with China may rise further this year, perhaps as high as \$15 billion, which would place China's bilateral trade surplus with the United States second only to Japan.

The findings in today's report obviously raise a question as to whether it might not be appropriate to issue formal negotiations with China on currency manipulation, as was done with Taiwan and South Korea in 1988 in similar circumstances. And it serves, in my judgment at least, as a further factor to be considered as the Congress faces the issue of most-favored-nation status for China with respect to our trade relationships.

We're very pleased this afternoon to welcome to testify on the report the very able Under Secretary of the Treasury for International Affairs, David Mulford.

After we've concluded with Secretary Mulford's testimony and the exchange with him, we will hear from Fred Bergsten, Director of the Institute for International Economics, and a former Assistant Secretary of the Treasury for International Affairs, who will comment on the recent G-7 meeting and other developments with respect to economic policy and exchange rate policy.

Mr. Secretary, we're very pleased to have you back before the committee. Please proceed.

STATEMENT OF DAVID MULFORD, UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. MULFORD. Thank you, Mr. Chairman. I would like to take about 10 minutes to present summary testimony to you, if I may. And it's, of course, always a great pleasure to be here with this committee and with you to discuss these reports, which, as you've pointed out, we've now been doing for 4 years. And they have resulted in, at least in my opinion, a very useful consultation process between the Congress and the administration on these complex economic issues.

The international economic policy coordination among the major industrial countries is an essential mechanism for achieving a sound world economy. The G-7 coordination process has produced

greater convergence in economic policies that has resulted in significantly improved economic performance: Eight years of sustained G-7 growth, more stable exchange rates which better reflect underlying competitiveness, and sharply reduced trade imbalances.

Today, the G-7 confronts the need to assure a strong global economic recovery. The basis for such an economic recovery is being established, and some encouraging signs are emerging. Inflation is clearly headed downward in most industrial countries. Interest rates have declined in some countries, and external imbalances have been reduced.

At the same time, however, there are continuing uncertainties regarding the timing and the strength of recovery, in part, due to the persistence of high real interest rates. In addition to the recession in the United States, the United Kingdom and Canada, economic activity is slowing in other countries which, until recently, were experiencing strong expansion.

At their April meeting, the G-7 emphasized the importance of monetary and fiscal policies which provide the basis for lower real interest rates and a sustained global economic recovery with price stability. They reiterated the importance of policies aimed at increasing global savings, and they reaffirmed their commitment to cooperate closely on exchange markets.

There have been some misperceptions about the U.S. approach to advancing these objectives. The United States has never advocated abandoning vigilance against inflation. Rather, we have argued that our priority is to restore strong G-7 growth while protecting gains on the inflation front. In our view, the reduction in inflation, which is now underway, gives us room to pursue a more growth-oriented strategy for the world economy.

While the major industrial countries bear a special responsibility for the smooth functioning of the world economy, other economies, particularly the newly industrialized economies of Asia, have an increasingly important role to play in promoting sustained growth and adjustment of external imbalances.

Korea's external accounts have undergone substantial adjustment over the past 2 to 3 years. This adjustment follows the sizable real appreciation of the one in 1988 and early 1989, and introduction of the market average rate system of exchange rate determination in March 1990. For the first time since 1985, Korea's current account fell into modest deficit in 1990 and a small deficit is also expected in 1991. Korea's bilateral trade surplus with the United States fell sharply, by nearly 40 percent, in 1990. Korea's foreign reserves declined in the first quarter of 1991. Also, there is no evidence that the Bank of Korea is intervening directly in foreign exchange markets.

Thus, at this time, there is no basis for concluding that Korea is directly "manipulating" its exchange rate for purposes of competitive gain. Nor does it appear at this time that Korea is using its comprehensive capital and exchange controls to manipulate the exchange rate indirectly for the purpose of gaining unfair competitive advantage.

Nevertheless, Mr. Chairman, we remain seriously concerned that pervasive Korean exchange and capital controls do significantly constrain supply and demand in the currency market. The ex-

change rate determination system in place, while an improvement over the previous regime, is far from a truly market-determined exchange rate system. Moreover, fundamental denials of national treatment for foreign financial institutions in Korea remain. Liberalization of the financial system is imperative to strengthen the role of market forces in exchange rate determination and in trade and investment flows, and would contribute significantly to the prospects for sustaining Korea's recent external adjustment.

The Department of the Treasury views these issues as evidence that the Korean Government is unwilling, in certain important areas, to address the fundamental concerns of the United States. The Treasury Department will continue to monitor developments in Korea's exchange rate and external adjustment, and through our ongoing financial policy talks with the Ministry of Finance, to press for liberalization of Korea's foreign exchange and financial markets.

Taiwan's global current account surplus decreased by 4.6 percent in 1990 to \$10.9 billion, or 6.7 percent of its GNP. This included a 10-percent drop in its global trade surplus to \$12.5 billion. Taiwan's bilateral trade surplus with the United States also fell by 14 percent to \$11.2 billion. We are encouraged by these reductions in Taiwan's external surpluses and by the continued liberalization of the exchange rate system, which now more accurately reflects market forces. We do not believe that, at this time, Taiwan is "manipulating" its exchange rate within the meaning of the legislation for the purpose of unfair competitive gain.

However, Taiwan's external surpluses remain too large and their decline needs to be accelerated with continued strong growth, sizable external surpluses and greater domestic political stability. We would expect to see a renewed trend toward broad appreciation of the NT dollar. In addition, Taiwan's remaining exchange and capital restrictions still impede the operation of market forces in exchange rate determination. We will continue, therefore, to monitor carefully this situation and urge the authorities to liberalize more rapidly controls on capital and foreign exchange transactions.

Balance of payments and foreign exchange developments in China are a growing concern. China's current account, which had been in deficit in recent years, moved to a large surplus of roughly 2.8 percent of GNP in 1990. China's large and growing trade surplus with the United States rose 67 percent to \$10.4 billion in 1990 as, indeed, you, yourself, pointed out, Mr. Chairman.

The principal cause of China's external surpluses appears to be generalized and pervasive administrative controls over external trade and payments. These controls are used to inhibit imports, including from the United States, and to promote exports, particularly to the United States, China's largest market. The controls include a restrictive foreign exchange allocation system, as well as trade barriers. There is no clear evidence at this time of "manipulation" of the exchange rate itself within the meaning of the law. Trade and foreign exchange allocation controls, rather than the exchange rate itself, have played the central roles in fostering the surpluses which have emerged so far.

However, recent devaluations of the official yuan do raise some concerns and indicate that a shift in exchange rate policy may be

occurring aimed at reinforcing China's ability to generate sizable external surpluses. Given the substantial real depreciation of the yuan to date and China's reluctance to eliminate export subsidies and liberalize imports, no case can be made, in our view, for further real effective depreciation.

The controls and surpluses to which they contribute are a matter of concern to the U.S. Government. Therefore, we intend to discuss China's foreign exchange policies with its authorities with a view to seeing China move toward a more market-oriented exchange rate and allocation system.

Thank you very much, Mr. Chairman.

[The complete prepared statement of David Mulford follows:]

FOR RELEASE UPON DELIVERY
EXPECTED AT 2:00 P.M.
MAY 16, 1991

STATEMENT OF THE HONORABLE
DAVID C. MULFORD
UNDER SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY
UNITED STATES SENATE
MAY 16, 1991

Mr. Chairman and members of the Committee:

It is a great pleasure to discuss with you the Department of the Treasury's latest report on international economic and exchange rate policy. These reports and the consultations with Congress on U.S. international economic policy have proven highly effective in increasing understanding of global economic developments and in advancing U.S. international economic objectives.

Economic Policy Coordination

International economic policy coordination among the major industrial countries is an essential mechanism for achieving a sound world economy. The integration of global trade and financial markets and the emergence of instantaneous world-wide communications require that domestic policies must increasingly take account of foreign economic developments and consequences. Policymakers in the major industrial countries have thus recognized the need to work together and share responsibility to achieve the benefits of an open, growing international economy.

The G-7 policy coordination process has produced greater convergence in economic policies among participants, resulting in significantly improved economic performance. Its record has been impressive:

- o The G-7 countries experienced the longest postwar expansion on record -- eight years of sustained growth.

- o Exchange rates now better reflect underlying competitiveness and are more stable.
- o Trade imbalances have been sharply reduced in the United States and Japan. In 1990, the U.S. current account deficit fell to 1.8 percent of GNP, from its 1987 peak of 3.6 percent. We expect further improvement this year. At the same time, the Japanese current account surplus dropped from its 1987 peak of 3.6 percent of GNP to 1.2 percent in 1990. Moreover, in 1990, the German surplus began to shrink for the first time in ten years, largely as a result of unification.

Today, the G-7 confronts the need to assure a strong global economic recovery. The basis for such an economic recovery is being established and some encouraging signs are emerging. Inflation is clearly headed downward in most industrial countries due to moderating economic activity and a reversal of the temporary surge in oil prices. The IMF expects that average G-7 inflation will fall from 5.5 percent in the year to the fourth quarter of 1990 to about 4 percent in the year to the fourth quarter of 1991. Interest rates have declined in some countries, and external imbalances are reduced.

At the same time, however, there are continuing uncertainties regarding the timing and strength of recovery, in part due to the persistence of high real interest rates. In addition to the recession in the United States, United Kingdom, and Canada, economic activity is slowing in other industrial countries, including those which until recently were experiencing strong expansion. The IMF has revised its forecast for 1991 G-7 growth downward from 2.4 percent to 1.3 percent.

At their April meeting, the G-7 emphasized the importance of monetary and fiscal policies which provide the basis for lower real interest rates and a sustained global economic recovery with price stability. They agreed that such a medium-term strategy is the best way to reduce the potential risks and uncertainties in the current outlook. They reiterated the importance of policies aimed at increasing global savings. And they reaffirmed their commitment to cooperate closely on exchange markets.

There have been some misperceptions about the approach which the U.S. has advocated in order to advance these objectives. The United States has never advocated abandoning vigilance against inflation. Rather, we have argued that our priority is to restore strong G-7 growth, while protecting the gains that we have made and that are in store on the inflation front. In our view, the reduction in inflation which is now underway gives us room to pursue a more growth-oriented strategy for the world economy.

Asian Newly Industrialized Economies and China

While the major industrial countries bear a special responsibility for the smooth functioning of the world economy, other economies -- particularly the newly industrialized economies of Asia -- have an increasingly important role to play in promoting sustained growth and adjustment of external imbalances.

Pursuant to Section 3004 of the Omnibus Trade and Competitiveness Act of 1988, we concluded in our October 1988 and April 1989 reports on International Economic and Exchange Rate Policy that Taiwan and Korea "manipulated" their exchange rates within the meaning of the legislation.

Following the first of our reports, the Treasury Department initiated bilateral negotiations with Taiwan and Korea, aimed at assuring that their foreign exchange policies contributed to the adjustment of global imbalances. We have made progress in these bilateral discussions. But major problems remain.

Korea's external accounts have undergone substantial adjustment over the past two to three years. This adjustment follows the sizeable real appreciation of the won in 1988 and early 1989 and introduction of the "market average rate" system of exchange rate determination in March 1990. For the first time since 1985, Korea's current account fell into modest deficit in 1990 and a small deficit is also expected in 1991. Korea's bilateral trade surplus with the United States fell sharply by nearly 40 percent in 1990. Korea's foreign reserves declined in the first quarter of 1991. Also, there is no evidence that the Bank of Korea is intervening directly in the foreign exchange markets.

Thus, at this time, there is no basis for concluding that Korea is directly "manipulating" its exchange rate for purposes of competitive gain, nor does it appear at this time that Korea is using its comprehensive capital and exchange controls to "manipulate" the exchange rate indirectly for the purpose of gaining unfair competitive advantage.

Nevertheless, we remain seriously concerned that pervasive Korean exchange and capital controls significantly constrain supply and demand in the currency market. The exchange rate determination system in place, while an improvement over the previous regime, is far from a truly market-determined exchange rate system. Moreover, fundamental denials of national treatment for foreign financial institutions in Korea remain. Liberalization of the financial system is imperative to strengthen the role of market forces in exchange rate determination and in trade and investment flows, and would contribute significantly to the prospects for sustaining Korea's recent external adjustment.

The Department of the Treasury views these issues as evidence that the Korean Government is unwilling in certain important areas to address the fundamental concerns of the United States. The Treasury Department will continue to monitor developments in Korea's exchange rate and external adjustment, and, through our ongoing Financial Policy Talks with the Ministry of Finance, to press for liberalization of Korea's financial, capital, and foreign exchange markets.

Taiwan's global current account surplus decreased by 4.6 percent in 1990 to \$10.9 billion, or 6.7 percent of GNP. This included a 10 percent drop in its global trade surplus to \$12.5 billion. Taiwan's bilateral trade surplus with the United States also fell by 14 percent to \$11.2 billion.

We are encouraged by these reductions in Taiwan's external surpluses and by the continued liberalization of the exchange rate system, which now more accurately reflects market forces. We do not believe that at this time Taiwan is manipulating its exchange rate within the meaning of the legislation, for purposes of unfair competitive gain.

However, Taiwan's external surpluses remain too large, and their decline needs to be accelerated. With continued strong growth, sizeable external surpluses, and greater domestic political stability, we would expect to see a renewed trend toward broad appreciation of the NT dollar. In addition, Taiwan's exchange and capital restrictions, while less pervasive than Korea's, still impede the full operation of market forces in exchange rate determination and should be significantly relaxed. We will continue, therefore, to monitor carefully the situation and urge the authorities to liberalize more rapidly controls on capital and foreign exchange transactions.

Balance of payments and foreign exchange developments in China are a growing concern. China's current account, which had been in deficit in recent years, moved to a large surplus of roughly 2.8 percent of GNP in 1990. China's large and growing trade surplus with the United States rose 67 percent to \$10.4 billion in 1990.

The principal cause of China's external surpluses appears to be generalized and pervasive administrative controls over external trade and payments. These controls are used to inhibit imports, including from the United States, and to promote exports, particularly to the United States, China's largest market. The controls include a restrictive foreign exchange allocation system as well as trade barriers. Given China's substantial reserves, there is no basis for this rationing system except to control the volume, type, and sources of imports.

There is no clear evidence at this time of "manipulation" of the exchange rate itself within the meaning of the law. Trade and foreign exchange allocation controls, rather than the exchange rate itself, have played the central roles in fostering the surpluses which have emerged so far. However, the recent devaluations, in conjunction with the large external surpluses and the restrictions on access to foreign exchange, do raise concerns and indicate that a shift in exchange rate policy may be occurring aimed at reinforcing China's ability to generate sizeable external surpluses. Given the substantial real effective depreciation of the yuan to date and China's reluctance to eliminate export subsidies and liberalize imports, no case can be made for further real effective depreciation.

The controls, and the surpluses to which they contribute, are a matter of concern to the United States Government. Therefore, we intend to discuss China's foreign exchange policies with its authorities with a view to seeing China move toward a more market-oriented exchange rate determination and allocation system.

Conclusion

Mr. Chairman, we must work together to meet the challenges of our changing world economy. This dialogue on the international aspects of U.S. economic and exchange rate policies is an important element in this effort.

DEPARTMENT OF THE TREASURY

Report to the Congress

on

International Economic and Exchange Rate Policy

May 1991

TABLE OF CONTENTS

	<u>Page</u>
Part I Introduction	1
Part II Economic Situation in the Industrial Countries	2
Part III Developments in Foreign Exchange Markets	5
Part IV U.S. Balance of Payments	8
Part V Economic Policy Coordination	11
Part VI Asian Newly Industrialized Economies (NIEs) and China	13
Part VII Conclusions	29
Appendix: Tables and Charts	32

PART I: INTRODUCTION

Section 3005 of the Omnibus Trade and Competitiveness Act of 1988 (Pub. L. 100-418) requires the Secretary of the Treasury to submit to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Banking, Finance and Urban Affairs of the House of Representatives an annual report each October 15 on international economic policy, including exchange rate policy. In addition, Section 3005 requires that the Secretary shall provide a written update of developments six months after the initial report. Annual reports, pursuant to Section 3005, have been submitted in 1988, 1989, and 1990. Written updates of developments have been submitted in April of 1989 and 1990. This is the third update of developments to be submitted to Congress.

Part II of this report reviews the economic situation in the industrial countries. Part III analyzes developments in the foreign exchange markets, including the dollar's movement relative to the currencies of major trading partners and U.S. foreign exchange market intervention. Part IV examines the U.S. balance of payments situation and Part V reviews efforts by the major industrial countries to coordinate economic policies. Part VI provides a status report on developments in the Asian newly industrialized economies and China. The final part provides conclusions on the principal issues discussed in the report.

PART II: ECONOMIC SITUATION IN THE INDUSTRIAL COUNTRIES

Overview

After eight years of robust expansion, real GNP growth for the seven major industrial countries fell to 2.6 percent in 1990, and will likely fall further to the 1-1.5 percent range in 1991. The slowdown reflects recession in the United States, Canada, and the United Kingdom and decelerating growth in Japan, Germany, and elsewhere. On the bright side, industrial country inflation is likely to drop significantly in 1991, and external imbalances are expected to continue to be reduced.

Aggregate real GNP growth in the seven largest (Summit) countries slowed considerably to 2.6 percent in 1990, down from 3.3 percent in 1989 and 4.6 percent in 1988. Thus, 1990 represented the eighth consecutive year of growth in the G-7. The temporary run-up in oil prices and the uncertainties associated with the Gulf crisis contributed, however, to the overall slowdown. For the 24 members of the OECD as a whole, real GNP growth was 2.6 percent, compared to an average annual rate of 3.4 percent during the 1983-90 expansion. (See Table 1 on G-7 economic performance.)

Growth in the United States, Canada, and the United Kingdom slowed sharply over the course of 1990, with each moving into recession by the end of the year. Output growth also slowed, but less dramatically, in France and Italy. In contrast, growth in Germany and Japan accelerated. Thus the growth disparity between the United States and the other industrial countries increased, with U.S. growth of 1.0 percent for the year, and OECD growth outside the United States of 3.5 percent in aggregate. This differential contributed to the further reduction in the U.S. trade and current account deficits.

Inflation in the OECD countries was somewhat higher in aggregate terms in 1990 than it was in 1989, owing mainly to the temporary runup in world petroleum prices late last year. In addition, a number of factors, which affected consumer price indices but did not boost the underlying rate of inflation, temporarily raised recorded inflation. These factors included the temporary effects of bad weather on some crops, the introduction or increasing of consumption taxes, and higher mortgage interest rates (with a high weight in the Retail Price Index) in the United Kingdom.

Taking all these forces into account, consumer prices rose 6.3 percent on a weighted average basis in the OECD countries in 1990, compared to 5.8 percent in 1989. Turkey, Iceland, and Greece had the highest inflation rates. Inflation in the Summit countries alone was 5 percent (vs. 4.5 percent in 1989).

Among the G-7 (Summit) countries, the United Kingdom recorded the highest 1990 inflation rate (9.5 percent). This rate was particularly affected by special factors such as the introduction of the community charge (poll tax). Inflation rates in Italy (6.5 percent) and the United States (5.3 percent) also exceeded the Summit country average for the year. The lowest rates were recorded in Germany (2.7 percent) and Japan (3.1 percent). The rise of many currencies against the dollar during 1990 helped to limit the impact of higher world oil prices (denominated in dollars) on their domestic prices.

Trade and current account developments in 1990 were quite favorable for the goal of reducing external imbalances. The U.S. trade deficit fell once again, despite an \$11 billion increase in petroleum imports (mainly from higher oil prices, but also from an increase in the volume of oil imported). The deficit dropped to \$108.7 billion on a balance of payments basis, down \$6 billion from 1989. The U.S. current account deficit fell to \$99.3 billion, the lowest level since 1984. The current account deficit was equal to 1.8 percent of GNP, one half the 1987 peak of 3.6 percent of GNP (\$162.3 billion).

Japan's external surpluses also fell, with the current account surplus declining from \$57 billion in 1989 to \$35.8 billion in 1990. This \$21 billion reduction -- about \$6 billion of which was attributable to higher oil prices -- brought Japan's current account surplus down to 1.2 percent of GNP from the 1987 peak of 3.6 percent of GNP (\$87 billion).

Germany's current account surplus fell to \$44.5 billion (2.7 percent of GNP), after a peak of \$55.3 billion (4.6 percent of GNP) in 1989. While higher oil prices played a role, the principal factor was strong demand for imports (both in the west, where real total domestic demand grew 5.1 percent last year; and in the eastern states, as one effect of reunification). Germany's \$50.3 billion trade surplus with its EC trading partners fell by a third, after tripling between 1985 and 1989.

Current account deficits for both the United Kingdom and Canada remained sizeable (2.4 percent) in relation to GDP last year. But the United Kingdom's deficit fell by \$8 billion, to \$22.8 billion, as the economy moved into recession. Canada's deficit was little changed in dollar terms, at \$13.7 billion. France and Italy again recorded deficits of moderate size.

The year 1991 is likely to record very low aggregate real GNP growth in the industrial countries -- perhaps in the 1 to 1.5 percent range. A significant slowdown in growth is projected in Germany and Japan. Growth is also projected to be lower in the major continental European countries. The slow average growth projection for the year also reflects recession in the United States, Canada and the United Kingdom in the early months of 1991.

While there are some encouraging signs of prospective economic recovery, the global outlook contains substantial risks, given the persistence of high real rates which generate uncertainties about the strength and timing of increased growth. For example, real short term interest rates in 1990 were 4.5 percent and 5.8 percent in Japan and Germany, respectively, compared to 2.4 percent in the United States.

Inflation prospects for the G-7 countries in aggregate, on the other hand, are favorable. With the passing of last fall's temporary rise in world petroleum prices, slower growth encouraging price and wage moderation, and some special statistical factors in consumer price indices no longer present, inflation rates are expected to decline this year. On a year average basis the decline is likely to be small, but average G-7 inflation is expected by the IMF to fall from 5.5 percent in the year to the fourth quarter of 1990 to about 4 percent in the year to the fourth quarter of 1991.

A further decline in current account imbalances is in prospect for this year. Slower growth in the U.S. will hold down import levels, while the more moderate slowdown abroad will help sustain U.S. exports. There will also be a large temporary reduction in the U.S. deficit as transfers are received from foreign governments in connection with international cooperation in the Persian Gulf. (The effect of these transfers on the balance of payments depends in part on whether they are received in cash or in kind -- only the former would be recorded in the current account.) The current account surpluses of Japan and Germany are also likely to fall, the latter by a considerable margin as imports by the eastern states continue to rise.

PART III: DEVELOPMENTS IN FOREIGN EXCHANGE MARKETS

Overview

Since the October 1990 report, the dollar has appreciated 5.2 percent against the yen and 9.8 percent against the deutschemark. Continental European currencies followed the movement of the dollar versus the deutschemark. The Canadian dollar, the currency of the United States' largest trading partner, remained roughly unchanged against the dollar. (See Table 2.)

On a real, trade-weighted basis, measured against the currencies of 40 developed and developing country trading partners, the dollar's March 1991 value was 4 percent above its October 1990 level. Measured on this basis, the dollar was about at the same level as in early 1980, prior to the 1980-84 appreciation. (See Chart.)

Demand for the dollar increased somewhat in the last quarter of 1990 as a hedge against uncertainty about the Gulf crisis and the Soviet Union. A brief shift out of the dollar occurred in mid-January to mid-February due to movements in interest rate differentials against the dollar and as the favorable conduct of the Gulf War dampened safe haven demands for the dollar. However, market confidence in the dollar returned in the wake of the quick conclusion of the Gulf War, optimism about the outlook for the U.S. recovery, and selling pressures on the deutschemark.

Late 1990

During the final quarter of 1990 and into early January 1991, the dollar drifted upward, boosted by occasional surges in demand for dollar liquidity prompted by market concerns over the risk of war in the Gulf and instability in the Soviet Union. The upward trend was tempered, however, by the slowdown in U.S. economic activity compared to that abroad, and the risk of adverse economic effects from a prolonged Gulf war. Moreover, short-term interest differentials moved further against the dollar during this period, particularly between the United States and Germany. Divergent movements in interest rates resulted in a differential of more than a percentage point between rates for U.S. and German short-term (3-month) assets.

On balance, events in the Gulf at times prompted dollar demand. But as concerns over economic fundamentals reasserted themselves among participants, the lower returns on dollar assets began to depress demand for dollars.

Mid-January to Mid-February 1991

From mid-January to mid-February, the dollar came under selling pressure as it appeared that the Gulf war would not generate sustained safe haven demand for dollars, but might act to depress economic activity. Interest rate differentials unfavorable to the dollar widened further as many believed that the land phase of the war would be lengthy and act as a substantial drag on the U.S. economy.

With military action underway in the Gulf, the G-7 Finance Ministers and Central Bank Governors agreed at their January 21 meeting to strengthen cooperation and to monitor developments in exchange markets. The Ministers and Governors stated that they were "prepared to respond as appropriate to maintain stability in international financial markets." This statement and subsequent intervention to support the dollar reassured the market concerning the G-7 commitment to cooperative action.

The downward pressure on the dollar continued, however, particularly against the deutschemark. The Bundesbank raised official German interest rates on January 31 (a move not generally anticipated in the market) and the Federal Reserve lowered official U.S. interest rates on February 1. Shortly thereafter, U.S. monetary and economic officials voiced dissatisfaction with the dollar's depreciation and optimism about the prospects for economic recovery. A brief episode of concerted dollar purchases by G-7 monetary authorities was also initiated at that time which provided significant support to the dollar.

These official interest rate actions, in retrospect, may have marked a turning point in the foreign exchange markets, with a shift in market psychology in favor of the dollar. This was influenced by an increasingly critical market view of developments in the German economy, Eastern Europe and the Soviet Union.

Mid-February through Mid-April 1991

With the end of the war, market optimism about U.S. economic prospects increased and a period of sustained and rapid appreciation of the dollar began. The dollar rose at times in March as many market participants decided that the dollar had "bottomed out". Moreover, participants focussed on the German mark, which was influenced by concerns over developments in the Soviet Union, East Europe, and the reunification of eastern Germany. Corporate treasurers and institutional investment managers made previously deferred dollar purchases. At this time, U.S. monetary authorities intervened out of concern about the rapidity of the dollar's rise.

Demand for dollars during this period was reinforced as the view took hold that the U.S. economy would likely begin its recovery around mid-year. There was still a note of caution, however, in that market participants expected the recovery to be moderate. Also, many participants believed that the U.S. monetary authorities would view a further rapid rise of the dollar with some concern, given the potential risks to U.S. trade competitiveness.

A major factor in the strength of the dollar during this period was a slackening of demand for deutschemark assets. While many had expected German reunification to produce rapid growth of investment in east Germany, the productive capacity and investment appeal of east Germany proved weaker than initially expected. The market regarded the tax increases in Germany -- announced early in the year -- as an admission by the German government that it had underestimated the cost of integrating west and east Germany.

In addition, demand for German assets declined in light of deteriorating political and economic conditions in the USSR. Many participants were concerned about Germany's ability to cope with both the costs of unification and the possibility of large-scale immigration into Germany from the Soviet Union.

PART IV: U.S. BALANCE OF PAYMENTS

Developments in 1990

The U.S. trade deficit continued to decline gradually in 1990, to \$109 billion from \$115 in 1989 (balance of payments basis). This represents a decline of \$51 billion, or nearly one-third, from the peak deficit of \$160 billion in 1987. (See Tables 3 and 4.)

Total 1990 exports, at over \$389 billion, were up nearly \$29 billion or 8 percent (9 percent in volume) from their 1989 level. Export growth, though still robust, slowed substantially from the double-digit rates of 1988 (28 percent in value terms; 24.5 percent in volume) and 1989 (12.5 percent and 11.4 percent, respectively). However, a major portion of the extremely rapid export increases during 1988-89 constituted "catch-up" of market share lost during the earlier period of extreme dollar strength. More recently, sustaining U.S. export growth has involved the challenging task of increasing market share beyond previous peak levels. In this light, the continued growth of U.S. exports at rates well above the growth of major markets abroad has confirmed that the competitiveness of U.S. products remains strong.

As in 1989, roughly one-half of the increase in 1990 exports was accounted for by capital goods. Consumer goods and industrial supplies and materials each contributed about one-quarter of the increase; other categories showed little change year-over-year. On a geographic basis, nearly one-half of the increased exports went to Europe, with the remainder spread across other geographic areas. Robust demand growth, and sustained U.S. export competitiveness, led to double-digit growth in the value of exports to Europe, registering a 13 percent increase compared with a 6 percent increase to all other areas.

Imports for 1990 were \$498 billion, up \$23 billion, less than 5 percent in value terms, from their 1989 level. Half the increase was in oil imports, partly though not entirely due to a sharp run-up in oil prices late in the year, related to the Gulf crisis. The remainder was in imports of capital and consumer goods. Imports from Japan and the Asian NIEs actually declined slightly, with the bulk of the increase in imports coming in trade with OPEC. Continued moderation in import growth will be an essential element in further trade deficit reduction.

Reflecting these import and export developments by product and area, the trade balance vis-a-vis Western Europe switched from a \$4 billion deficit in 1989 to a modest surplus of over \$2 billion in 1990. The balance vis-a-vis Japan and the Asian NIEs -- though remaining in deficit -- also improved, although about one-half of the improvement reflected lower U.S. imports rather than export gains, as was the case for the balance with Western Europe.

The 1990 current account deficit, at \$99 billion, was under \$100 billion for the first time since 1984. Roughly one-half (\$6 billion) of the \$11 billion improvement from 1989's \$110 billion deficit reflected the trade balance improvement, discussed above. The remaining \$5 billion came from an increase in the net inflow for all other components of the current account combined: investment income, services, and transfers.

The increase in net investment income was extremely large, over \$8 billion. In large part, this reflected a decline in U.S. earnings of foreign direct investors, which, in turn, was related to the more moderate pace of activity in the U.S. economy. Net receipts on services other than investment income registered a modest increase of over \$2 billion, continuing the gradual upward trend of recent years. Offsetting these increased inflows was an increase in the net outflow for unilateral transfers of over \$6 billion, principally reflecting forgiveness of debt owed by Egypt. (The impact of the grant to Egypt was partly offset by receipts of cash support from coalition partners for Operation Desert Shield.)

Financing of the 1990 current account is obscured by the extremely large (\$73 billion) statistical discrepancy, which is thought generally to reflect unrecorded capital flows. The recorded inflow of capital from net investments by private foreigners was exceeded by the recorded outflow of investments abroad by U.S. investors. Aside from the statistical discrepancy, the other source of net capital inflows was an increase in foreign official holdings of U.S. assets.

Prospects for 1991

The prospect for 1991 is for a substantial further decline in the trade deficit. The current account should show a similar underlying trend, but, in addition, contributions by allies in support of Operation Desert Storm will give a one-time, dramatic increase in invisible receipts producing a very large one-time decline in the current account deficit in 1991.

Exports should continue to show steady growth, similar to the 1990 performance. The U.S. competitive position remains solid: despite recent dollar fluctuation, on a trade-weighted basis against a basket of currencies, it remains within the ± 10 percent or so band observed since its 50 percent decline in 1985-87. In addition, growth in markets abroad remains solid, although there are emerging concerns that growth in Europe and Japan may slacken over the course of this year.

Non-oil import growth in 1991 should remain low, though it should pick up somewhat during the course of the year from the very low 3 percent value growth for 1990 as part of the normal part of a cyclical recovery. The value of oil imports is likely to decline in 1991, reflecting lower average oil prices. While the volume of oil imports may rise, as depleted stocks are rebuilt in the early part of the year and demand picks up in the latter part of the year, the oil price decline is likely to be larger than the volume increase.

These trends point to a 1991 trade deficit in the \$90 billion range, below \$100 billion for the first time since 1983. In addition, further underlying progress is being made in reducing the current account deficit. Thus, the current account deficit may fall to around \$75 billion, excluding the one-time impact of Desert Storm contributions. Including these contributions, the current account deficit could even be below \$40 billion.

PART V: ECONOMIC POLICY COORDINATION

The world economy has become increasingly interdependent in recent years and, more and more, economic power and responsibility are shared in view of the greater balance among nations. The linkages among major economies are being heightened by the globalization of flows of goods, services, and investment. Financial markets involve around-the-clock trading. Against this background, countries continue to pursue their own self interests. But they increasingly recognize that they must work collectively to achieve their shared objectives.

The pursuit of international economic policy coordination in the G-7 has become essential for achieving these shared objectives. Indeed, over the years, the G-7 have made significant progress in implementing consistent policies for sustained growth with price stability, reduced external imbalances, and greater stability of exchange markets. Furthermore, economic policy coordination has been extended to a wide range of international economic policy issues. Thus, the G-7 have in recent years addressed such issues as cooperation in the Persian Gulf, the transformation of Eastern European economies, and the international debt strategy, as well as a range of other international financial issues concerning individual countries and the international financial institutions.

The meeting of the G-7 Finance Ministers and Governors on January 20-21, 1991, reflected this reality. The Ministers and Governors met against the background of the Gulf war, reaffirming their support for economic policy coordination and agreeing to strengthen cooperation to maintain stability, as appropriate, in international financial markets in light of the uncertainties arising from the Gulf war and developments then taking place in the Soviet Union.

More recently, the G-7 Ministers and Governors met on April 28, in the context of an economic environment that had substantially changed during the preceding months. Several major economies were experiencing recession. Economic activity was slowing in other industrial countries, including those which had been experiencing strong expansion. Indeed, the IMF had marked down significantly its projection for G-7 growth in 1991 to 1-1/4 percent, a full percentage point lower than the October 1990 projection.

Furthermore, other important changes in the world economy with significant medium-term implications have been occurring. In this context, the Ministers and Governors welcomed the critical reform efforts underway in Eastern Europe, Latin America, and other developing countries, and agreed that a strong global economic recovery and open markets in the major industrial countries will provide necessary support for these efforts.

At their meeting, the G-7 noted the hopeful signs of recovery in some quarters. In particular, there were indications of a prospective economic recovery and lower inflation in those countries which were in recession. Adjustment of structural fiscal deficits was underway in the United States and a number of other countries which would strengthen public savings. External imbalances have been further reduced. Interest rates in the United States, in particular, have declined.

But a recovery of world economic activity is by no means certain. High real interest rates persist in many countries, dampening investment and growth prospects, and economic activity is slowing in those countries which until recently had been experiencing strong expansion.

Fostering an open, growing world economy is the most effective tool to meet the challenges of the world economy. The Ministers and Governors therefore emphasized the importance of monetary and fiscal policies which provide the basis for lower real interest rates and a sustained global economic recovery with price stability. They agreed that such a medium-term strategy was the best way to reduce the potential risks and uncertainties in the current outlook. And they reaffirmed their commitment to cooperate closely on exchange markets. In the period ahead, it will be important to take concrete actions to strengthen prospects for sustained growth with price stability.

**PART VI: ASIAN NEWLY INDUSTRIALIZED ECONOMIES
(NIEs) AND CHINA**

Overview

Since mid-October 1990, Korea's currency has depreciated some 1.5 percent against the U.S. dollar, while Taiwan's has remained virtually unchanged. Over the longer term, since the Plaza Agreement in September 1985, the NT dollar has strengthened by 48.6 percent and the Korean won by 23.2 percent against the U.S. dollar (see Table 5).

The decline in the U.S. merchandise trade deficit with the Asian NIEs as a group -- Korea, Taiwan, Hong Kong, and Singapore -- continued in 1990. In 1990, the trade deficit with the Asian NIEs was \$19.7 billion, down \$4.6 billion or 19 percent from 1989. This compares to a 7 percent decline in the overall U.S. trade deficit. As a proportion of the overall U.S. trade deficit, the deficit with the NIEs fell from 22 percent to 20 percent between 1989 and 1990. In the first two months of 1991, the trade deficit with the NIEs was \$1.6 billion, 51 percent below the same period of 1990.

At the same time, the U.S. trade deficit with China has risen. In 1990, the trade deficit with China was \$10.4 billion, an increase of 68 percent over 1989. The bilateral trade deficit with China is now our third largest, after Japan and Taiwan.

Under Section 3004 of the 1988 Trade Act, the Secretary of the Treasury is required to "...consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade. If the Secretary considers that such manipulation is occurring with respect to countries that (1) have material global current account surpluses and (2) have significant bilateral trade surpluses with the United States, the Secretary of the Treasury shall take action to initiate negotiations...on an expedited basis...for the purpose of ensuring that such countries regularly and promptly adjust the rate of exchange between their currencies and the United States dollar."

It was concluded in the October 1988 report that Taiwan and Korea "manipulated" their exchange rates, within the meaning of the legislation. Pursuant to Section 3004, the Treasury was required to initiate bilateral negotiations with Taiwan and Korea for the purpose of ensuring that these two economies regularly and promptly adjust the rate of exchange between their currencies and the U.S. dollar to permit effective balance of payments adjustment and to eliminate the unfair advantage.

In April 1990, the Treasury concluded that Taiwan and Korea were no longer directly "manipulating" their currencies within the meaning of the legislation. This finding was reaffirmed in November 1990. It was noted, however, that particularly Taiwan's external surpluses remained large. In addition, it was noted that in both Taiwan and Korea, exchange rate policy would continue to have an important role to play in furthering their economic adjustment. Furthermore, it was noted that, particularly in Korea, liberalization of remaining exchange and capital controls was required to improve the functioning of the exchange markets and assure full scope for market forces in exchange rate determination.

Our large and growing bilateral trade deficit with China, substantial depreciation of the yuan in 1990, and administrative controls over foreign exchange allocation, have prompted serious concern as to the applicability of Section 3004 to China. This issue will be analyzed below.

Following is a summary of economic and exchange rate developments in Korea, Taiwan, and China.

Korea

The steady depreciation of the Korean won in nominal terms against the U.S. dollar has continued since the last report. The won has depreciated by 1.5 percent since mid-October 1990 and 8 percent since its peak in April 1989. In real terms (i.e., adjusted for U.S.-Korean inflation differentials), however, the won has shown little change against the U.S. dollar over the past year as inflation in Korea has remained high.

The renewed nominal depreciation of the won reflects in part the adjustment in Korea's external accounts, which moved into a modest deficit in 1990. However, the exchange rate also continues to be influenced by pervasive foreign exchange and capital controls in Korea. These controls constrain the forces of supply and demand in the exchange market, distort trade and investment flows, and position the authorities to manipulate the exchange rate through indirect means.

o Exchange Market Developments

Under the "market average rate" (MAR) system of exchange determination, introduced on March 2, 1990, the won/dollar exchange rate at the beginning of each business day is equal to the weighted average of transactions in the inter-bank market on the preceding business day. Inter-bank and customer rates are allowed to float freely within specified margins. Exchange rates between the won and third currencies are set in accordance with dollar rates in international currency markets.

During the first thirteen months of the MAR system (through April 12, 1991), the won depreciated 4.4 percent in nominal terms against the U.S. dollar and 6 to 13 percent against most other G-7 currencies. Foreign banks accounted for a large share of transactions in the inter-bank market, generally 40-60 percent of the total. The Bank of Korea (BOK) was not a direct participant in the market, and other government-owned banks accounted for only a small share of inter-bank activity.

Since the Plaza Agreement in September 1985, the won's cumulative nominal appreciation against the U.S. dollar now stands at 23.2 percent. However, much of that appreciation occurred in 1988 and first quarter of 1989; the won peaked at 665/dollar in April 1989 and has depreciated roughly 8 percent in nominal terms against the dollar since then. The cumulative nominal depreciation against the dollar since the first of these reports was issued in October 1988 now stands at 2.1 percent.

In real effective terms, i.e., taking into account movements of the won against major trading partners as well as relative inflation rates, the picture is somewhat different. On this basis, we estimate that the won appreciated some 11 percent between October 1988 and the middle of 1989. Since that time, the won has steadily depreciated in real effective terms, with the result that its cumulative real effective appreciation since October 1988 now stands at only 2.3 percent.

o Foreign Exchange and Capital Controls

The Korean authorities maintain a comprehensive array of controls on foreign exchange and capital flows. These controls prevent market forces of supply and demand from playing a fully effective role in exchange rate determination, distort trade and investment flows, and provide the Korean authorities with tools for indirectly manipulating the exchange rate.

Foreign exchange banks are required to obtain and review, prior to entering into spot customer foreign exchange transactions, original documentation of an underlying trade (or other) transaction. This requirement makes it virtually impossible for banks to conduct foreign exchange business over the telephone and hampers the development of Korea's foreign exchange market. Other controls severely restrict the use of short-term trade finance, and there are effective limitations on a variety of current account transactions such as travel and remittances. Portfolio investment abroad by Korean individuals is restricted to participation in a limited number of Korean-managed unit trusts. Direct portfolio investment by foreigners in Korea is prohibited, although the Korean Government has announced that a limited, but as yet unidentified, opening of the domestic capital markets will occur sometime in 1992. The government also controls capital flows in connection with foreign direct investment in Korea, as well as investment abroad or foreign borrowing by Korean residents. These and other controls limit the ability of branches and subsidiaries

- 16 -

of foreign companies located in Korea to obtain investment and working capital and even import finance.

o Trade and Economic Developments

Domestic Economy

Korea's real GNP is estimated to have grown 9 percent in 1990, compared with 6.7 percent in 1989 and over 12 percent annually in 1986-88. Growth in 1990 was led by private consumption and fixed investment, with the construction and manufacturing sectors registering particularly strong performances. Inflation is estimated to have reached 8.6 percent in 1990. Unemployment remained low at 2.4 percent. In 1991, the real GNP growth rate is expected to remain strong at about 8 percent. Inflation is a growing concern, with the consumer price index rising at an annualized rate of nearly 20 percent in the first quarter of 1991.

External Accounts

Korea's external accounts have undergone substantial adjustment since 1989 largely because of the substantial real appreciation of the won in 1988-89. Other factors in the adjustment include: the strong growth of the domestic economy (drawing in greater imports); rising wage demands and other factors adversely affecting Korea's export competitiveness; and rising oil import prices and lost export opportunities in the wake of the Persian Gulf crisis.

For the first time since 1985, the current account fell into modest deficit in 1990, by \$2.1 billion (0.9 percent of GNP). This included a trade deficit of \$1.9 billion on a balance of payments basis, compared with a trade surplus of \$4.5 billion in 1989. Merchandise exports were up 4.2 percent in value terms from the previous year, while imports rose 13.6 percent. The current account deficit in the first quarter of 1991 reached \$3.9 billion. However, with exports recovering strongly and import growth slowing, the Bank of Korea projects that the deficit for all of 1991 will narrow to \$2 billion, implying a return to monthly current account surpluses later this year. This in turn suggests that, notwithstanding the Korean Government's earlier projection of a current account deficit in 1992, external surpluses are likely to reemerge from next year.

According to U.S. customs data, the U.S. bilateral trade deficit with Korea in 1990 fell to \$4.1 billion, down 38 percent from 1989. This was based on a 7 percent increase in U.S. exports to Korea and a 6 percent decline in imports from Korea. In the first two months of 1991, the United States ran a small trade surplus of \$13.5 million with Korea.

- 17 -

After declining steadily since 1985, Korea's gross external debt rose to \$31.7 billion by the end of 1990, compared with \$29.4 billion at the end of 1989. The 1990 gross debt figure is equal to only 13.5 percent of GNP, compared with 52 percent of GNP in 1985. Total interest and amortization payments declined from \$8.1 billion in 1989 to \$6.9 billion in 1990. As a ratio of exports of goods and services, debt service declined from 11 percent in 1989 to 9 percent in 1990. Gross official reserves at the end of 1990 totaled \$15 billion, representing 2.8 months of import coverage. With the negative trends in the current account, reserves fell to \$13 billion by the end of March 1991, about the same level as at end-1988, when Korea experienced its peak current account surplus.

Policy Developments

In the last report, we noted with concern that the Korean Government had strengthened its controls over various aspects of the economy during 1990 and postponed earlier plans to deregulate and liberalize. Responding to foreign expressions of concern about the direction of economic policy, senior Korean officials issued a series of public statements in the early part of 1991 affirming the Korean Government's commitment to free trade and calling on government ministries to alleviate economic tensions with other countries.

The Ministry of Finance has taken some concrete measures over the past year to improve the treatment of foreign financial institutions in Korea. These steps include an increase in the ceiling on issuance of certificates of deposit (CDs) by foreign banks in June 1990, elimination of the ceiling on foreign banks' paid-in capital in Korea, and extension of the operating hours of cash dispenser machines.

However, fundamental denials of national treatment for foreign financial institutions in Korea remain. These denials of national treatment manifest themselves in several areas. Notwithstanding the increase in CD limits, U.S. banks report severe and growing difficulties in meeting the local financing needs of their traditional clients. Swap lines, the chief source of local currency for foreign banks, have been cut several times since December 1987 without deep, viable alternative sources of funding being made available. Discrimination against foreign banks in the setting of interest rates in the interbank call money market has not abated. At the same time, the regulatory environment for foreign banks in Korea has been tightened, in a manner that lacks both transparency and consistency.

In the securities area, the Ministry of Finance has imposed stiff criteria for foreign branch establishment, including burdensome and discriminatory minimum capital requirements. These criteria are all the more onerous because the Ministry of Finance has not yet specified the range of permissible activities for

foreign securities branches in Korea when they are allowed to begin operating in 1992.

The Korean Government has also done little to address the need for broader liberalization of its tightly controlled financial markets, including deregulation of interest rates and elimination of credit allocation schemes.

The Department of the Treasury views these issues as evidence that the Korean Government is unwilling in certain important areas to address the fundamental concerns of the United States. We will continue to pursue them with the Korean Ministry of Finance through the bilateral Financial Policy Talks, and the Uruguay Round financial services negotiations.

Assessment

At this time, there is no basis for concluding that Korea is directly "manipulating" its exchange rate, within the meaning of the 1988 Trade Act, for the purposes of competitive gain, or that the Government is using the array of exchange and capital controls at its disposal to "manipulate" the rate indirectly. This assessment is based on the following factors: the reemergence of modest trade and current deficits in 1990, the likelihood that Korea will again post small external deficits in 1991, the decline in Korea's foreign reserves in the first quarter of 1991, the lack of evidence that the Bank of Korea is intervening directly in the exchange market, and the modest role of other government-owned foreign exchange banks in the market.

Nonetheless, we remain seriously concerned that pervasive Korean exchange and capital controls significantly constrain supply and demand in the currency market. The exchange rate determination system in place, while an improvement over the previous regime, is far from a truly market-determined exchange rate system. Liberalization of these controls is imperative to strengthen the role of market forces in exchange rate determination and in trade and investment flows, and would contribute significantly to the prospects for sustaining Korea's recent external adjustment.

Therefore, in the period ahead, the Treasury Department will continue to monitor developments in Korea's external accounts and the operation of the new market-average exchange rate system. In particular, with a return to external surpluses likely in 1992, we would expect to see a renewed trend toward appreciation of the won. We will also continue to press for liberalization of Korea's financial, capital, and exchange markets, as well as to seek improved treatment for U.S. financial institutions in Korea.

Taiwan

Since the October 1990 report, Taiwan's external surpluses have continued to fall, while the NT dollar has fluctuated within a small range. Factors such as the relocation of lower, value-added, export industries overseas; rising wages and production costs; and inflationary pressures have continued to play an important role in the decrease in the external trade surpluses over the past year. The expected slow growth over the near-term in Taiwan's major export markets, particularly the United States, in addition to the above elements, should lead to a further reduction in Taiwan's external surpluses this year. However, Taiwan's current account surplus, in nominal terms and relative to GNP, will still be unsustainably large.

o Exchange Rate Developments

Since the October 1988 report, Taiwan's cumulative exchange rate appreciation against the dollar has been only 6 percent in nominal terms. The NT dollar began 1990 at NT\$26.17/U.S.\$1 and depreciated by less than 1 percent during the first four months of the year. In mid-May 1990, the NT dollar depreciated by 4 percent to NT\$27.40/U.S.\$1 due to substantial net capital outflows caused by political uncertainties and slower economic growth. In June, the Central Bank sold U.S. dollars and imposed severe deposit requirements on foreign exchange accounts, inducing a firming of the NT dollar to NT\$27.20/US\$1. This, along with an improvement in the political situation, led to a reversal in capital flows in the second half of the year. Since mid-1990, the NT dollar has fluctuated within a small range against the U.S. dollar. The NT dollar depreciated against all other major currencies through 1990 as a whole. As of April 12, the exchange rate stood at NT\$27.28/US\$1.

Given the strength of Taiwan's economic fundamentals, the expectation of increased growth, a still large current account surplus, and a more stable political environment, there is every reason to expect strengthening of NT dollar in the months ahead.

o Trade and Economic Developments

Taiwan's global current account surplus decreased by 4.6 percent in 1990 to \$10.9 billion. As a proportion of GNP, this was a fall to 6.7 percent from 7.5 percent in 1989. Taiwan's overall trade surplus (cif basis) was down 10 percent last year from 1989 to \$12.5 billion.

The U.S. trade deficit with Taiwan in 1990 was 14 percent lower than in 1989 at \$11.2 billion. This reflects a 7 percent fall in U.S. imports from Taiwan. However, U.S. exports to Taiwan only increased by 1 percent.

According to Taiwan's data, our bilateral trade imbalance contracted by 24 percent to \$9.1 billion in 1990. Exports to the United States dropped by 9 percent, the steepest decline in 16 years. The U.S. share of Taiwan's exports fell 4 percentage points

to 32 percent. In addition, as a result of Taiwan's efforts to diversify its export markets and the growing demand from Taiwan's offshore industries, Asia replaced North America in 1990 as Taiwan's largest export market for the first time.

In 1990, real GNP growth fell to 5.3 percent from 7.3 percent in 1988 and 1989. The fall was due principally to the decline in private investment, inventories, and the trade surplus. However, given the pick-up in growth beginning in the last quarter of 1990 and strong expansion by the public sector, we expect growth this year to be close to the level of 1988-89. At the same time, inflation officially rose by 4.1 percent last year, although this is probably an understatement. Inflation is unlikely to improve this year.

Taiwan experienced a substantial rise in net capital outflow last year, due largely to sizable increases in overseas investment and short-term flows from NT dollar to foreign currency accounts. As a result, the overall balance of payments surplus plummeted 98 percent to just \$55 million, the lowest level in the past 10 years. Foreign exchange reserves, consequently, were virtually unchanged at \$72.4 billion, the world's second largest stock at the time.

The current account surplus is expected to continue to fall in 1991. This is the result of a lower merchandise trade surplus and increased service payments.

In the first quarter of this year, Taiwan's overall trade surplus fell by 9 percent over last year to \$1.6 billion.

The U.S. trade deficit with Taiwan in the first two months of this year totalled \$1.5 billion, a 12 percent decline from the comparable period in 1990. U.S. exports to Taiwan were up by 8 percent and imports from Taiwan down by 2 percent.

According to Taiwan's data, the trade surplus with the United States was down by 29 percent in the first 3 months of this year, due to a 7 percent decline in exports to the United States and a 5 percent increase in imports. The U.S. share of Taiwan's overall trade surplus fell to 81 percent, compared to 103 percent over the same period in 1990.

o Exchange Rate System

There is no evidence that the Central Bank has recently been intervening in the market consistently to gain competitive advantage. The Central Bank has, however, intervened to control short-term downward and upward pressure on the NT dollar, although not with the same dominance before the institution of the new exchange rate system two years ago. On a net basis, the Central Bank probably sold more U.S. dollars through intervention than it bought in 1990, thereby, favoring appreciation of the NT dollar.

Taiwan continued to take a number of measures to liberalize the system further and reduce capital controls over the past year and since the October 1990 report.

All foreign exchange transactions can now be freely determined, beginning with the announcement at end-1990 that authorized foreign exchange banks are permitted to set their own exchange rate for small foreign exchange transactions (less than \$10,000) that had formerly been fixed by a committee of banks.

The breadth of the foreign exchange call loan market (maturity ranges from overnight to six months) has been expanded in terms of eligible participants and tradable currencies. As such, daily turnover has risen dramatically to approximately \$1.2-1.5 billion. Fifty foreign exchange banks were permitted to participate at the establishment of the call loan market in August 1989. Since August 1990, headquarters and affiliated institutions of foreign banks in Taiwan, overseas branches of local banks, and all financial institutions in Singapore, New York, and London have been allowed to participate in the market. The tradable foreign currencies have been increased from only the U.S. dollar to all other 12 currencies listed on the foreign exchange market. The foreign exchange call loan market also signed a linkage agreement with Singapore early this year, on top of linkages already with Hong Kong, Tokyo, and Seoul.

In addition, the minimum one-month holding period for fixed-term foreign exchange deposits was eliminated in January 1991. The foreign exchange reserve requirement instituted in June 1990 to stem capital outflow was also rescinded in late-November.

The limit on foreign exchange (forex) liabilities of each foreign exchange bank was increased twice in 1990, by 30 percent in March and by 50 percent in August. The aggregate level for all foreign exchange banks was, thereby, raised to \$30 billion. The limit on the short (oversold) position of each foreign exchange bank was doubled to \$6 million in early August. These relaxations should broaden foreign exchange activities and make the NT dollar's value more open to market forces.

The limits on foreign exchange inflows and the amount of cash an individual can carry in and out of Taiwan were relaxed. (The cash maximum was raised 400 percent to a still small NT\$40,000 or \$1466.) The annual limit on non-trade related capital inflows was raised from \$2 million to \$3 million per entity in July. (Capital flows for trade purposes are unlimited.) At the same time, however, the annual limit on capital outflows was tightened from \$5 million to \$3 million, or the same limit for inflows.

The easing of the inflow restriction was, in part, a response to U.S. criticism in previous reports that the uneven limits on inflows and outflows distorted the operation of market forces and constituted a bias against appreciation. In that sense, the change

- 22 -

is welcome. Tightening the limit on outflows, however, was not a positive action, although it was probably instituted out of concern for the large movement of capital overseas in 1990. The Central Bank claims that the lower outflow limit will have little practical effect since over the last three years, the amount of outward remittances averaged only \$26,000, with just 4 cases out of 10,000 exceeding \$3 million. It is our expectation that the Central Bank will raise both limits in tandem as the market continues to be stable and it gains confidence.

The maintenance of restrictions on "long" and "short" foreign exchange positions and the method of calculating the foreign exchange positions of a bank effectively prevent a forward foreign exchange market from functioning. The cash or spot basis Taiwan uses to calculate a bank's foreign exchange position is contrary to normal international practice. Taiwan instituted a cash basis method in 1987 to deter pressure for NT dollar appreciation and to prevent foreign banks from doing forward foreign exchange transactions. That is, on a cash basis, forward foreign exchange positions are not counted. Taiwan should, thus, return to the Generally Accepted Accounting Practice norm of using an "accrual" basis in calculating foreign exchange transactions and allow the operation of a forward market.

The ceilings on foreign exchange positions also discriminate against foreign banks. For example, the limit on forex liabilities varies by bank, depending on the average outstanding balance over a certain period of time. In all likelihood domestic banks were forewarned of changes in the ceiling, allowing them to build up their outstanding balances beforehand. Moreover, the ceiling on overbought forex position is \$50 million per bank for the five large domestic banks and \$20 million per bank for all other banks, including the foreign banks. Finally, the limits on forex positions are based on local assets. The assets of foreign banks, however, are relatively small since Taiwan has restrictions on their operations and branches.

o Assessment

We are encouraged by the fall in Taiwan's external surpluses over the past year and the continued liberalization of the exchange rate system, which now more accurately reflects market forces. We have no evidence of direct exchange rate "manipulation" for unfair competitive purposes. There is still reason to be much concerned, however, about Taiwan's persistently large external surpluses, especially relative to GNP. As such, there is a need for a more rapid decline in these surpluses. Exchange rate appreciation will likely need to play a role in this process. Indeed, with continued strong growth, sizable external surpluses, and greater domestic political stability, a renewed trend toward broad appreciation of the NT dollar would be expected. Limitations on foreign exchange transactions and capital flows, while less pervasive than in Korea's case, remain too restrictive and impede the full operation

of market forces in exchange rate determination. Given Taiwan's advanced state of economic development, such limitations should be significantly relaxed. We will continue, therefore, to monitor carefully the situation and urge the authorities to further liberalize controls on capital and foreign exchange transactions.

China

In the October 1990 report, we noted China's tendency to run global current account and trade deficits since experimentation with economic and trade liberalization began in 1979. At the same time, we observed that China's bilateral trade surpluses with the United States had grown rapidly since 1985. China's exchange rate had been devalued periodically, but apparently not to the extent that the fall in the yuan had matched the pace of increase in Chinese inflation, thereby causing China to lose competitiveness. Since that report, however, there are mounting indications that China may seek to run significant current account and trade surpluses by combining devaluations of the yuan and tight controls over foreign exchange allocation with severe restrictions on imports.

o Exchange Rate System

China officially has a dual exchange rate system. There is an administered ("managed float") exchange rate which applies to transactions under the state trade plan. There is also a "floating" rate determined in the "foreign exchange adjustment (swap) centers" where foreign investment corporations and all domestic entities which are allowed to retain foreign exchange can conduct foreign exchange transactions based on rates agreed by the buyer and seller. This foreign exchange, however, can only be used to purchase "priority" products and transactions must be approved by the State Administration of Exchange Control. The swap centers were instituted in 1986 and have since then grown significantly in number (100) and breadth of transactions. There are also various internal settlement rates used to conduct transactions; for instance, between factories and foreign trade corporations. In addition to the official dual system, there is an active black market for foreign exchange trading.

o Exchange Rate Developments

There has not been a consistent pattern of nominal yuan devaluations against the dollar since the yuan (administered rate) was devalued by 15 percent in 1985 and another 17 percent in 1986. In December 1989, however, the administered rate was devalued in nominal terms by 21 percent to Yuan 4.72/US\$1 due mainly to a desire to reduce state subsidies to exporters who lose money on sales of products with higher domestic production costs than prevailing international prices. This depreciation was instituted in anticipation of eventual import liberalization, which has not,

however, materialized. The PRC then instituted another substantial devaluation (9.6 percent) of the administered exchange rate in late-November 1990, again with the stated purpose of unifying this rate with the swap market rate and lightening the budgetary burden of export subsidies. In addition, in early April, the yuan was devalued by 1 percent without a public announcement.

There are perhaps two interpretations of the latest moves. Firstly, this could be an indication that China will be pursuing a policy of more frequent and smaller changes, particularly devaluations, in the exchange rate to gain competitive advantage in a quieter fashion. Secondly, China could be responding to the advice of the international financial institutions to adjust the exchange rate more flexibly in preparation for convertibility. In either case, there is reason to monitor China's exchange rate movements closely.

China: Exchange Rate and Inflation

	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>
Exchange Rate (Yuan/\$; end-year)	3.20	3.72	3.72	3.72	4.72	5.22
Nominal Ex. Rate Index (Yuan/\$; end-year)	100	116	116	116	148	163
CPI Index	100	107	116	141	163	167
Real Effective Index (inflation adj., trade weighted; end-year)	100	78	73	87	81	61

From 1985 through 1988, nominal devaluation of the yuan against the dollar was not sufficient to offset the impact of rising prices in China. Thus, in real terms (i.e., adjusted for China-U.S. inflation differentials), the bilateral exchange rate appreciated against the dollar over this period. Since then, however, as noted above, the yuan has depreciated in real terms.

Against the broader range of currencies of China's trading partners, and adjusted for differentials between China's inflation and that of its major trading partners, the picture is somewhat different. On this basis, the yuan has depreciated significantly (see real effective index). Since 1985, the yuan had depreciated by 39 percent in real effective terms. During this period, the real effective exchange rate did appreciate sharply in 1988, but has since fallen again. In 1990 alone, the nominal devaluation in November and lower inflation (3 percent) resulted in a 25 percent effective devaluation.

At the same time, the exchange rates in the swap centers and black market are weaker than the administered rate, typically by 20 percent and 30 percent, respectively. This gap has narrowed recently, however. For example, in early 1991, the exchange rate in the swap centers was close to Yuan 5.7/US\$1, or approximately 9 percent below the value of the administered rate.

Given the large and growing external surplus, the apparent unwillingness to abolish export subsidies fully, and lack of reform of the trade system, there is certainly no justification for further devaluations. At the same time, while an appreciation of the administered official exchange rate could dampen external demand for China's exports, it would probably have little effect on the flow of imports given the number and complexity of other barriers to imports.

o Trade and Economic Developments

China has characteristically had overall trade and current account deficits in recent years. In 1990, however, China's merchandise trade balance moved to a \$9 billion surplus from a deficit of \$5.6 billion in 1989. The current account also went from deficit in 1989 to an estimated \$10.2 billion surplus in 1990, equal to 2.8 percent of GNP. This year, these surpluses are expected to increase by sizable amounts.

China: Current Account and Trade Balance (\$ Bn.)

	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>
Current Account	-11.4	-7.0	0.3	-3.8	-4.3	10.2
% of GNP	-3.9	-2.6	0.1	-1.0	-1.0	2.8
Global Trade Bal.	-13.1	-9.1	-1.7	-5.3	-5.6	9.0
% of GNP	-4.4	-3.2	-0.6	-1.4	-1.2	2.5
Trade Surplus w/U.S.	0	1.7	2.8	3.5	6.2	10.4
(U.S. data)						
% of GNP	0	0.6	0.9	0.9	1.3	2.9

According to U.S. customs value data, China has a large and growing trade surplus with the United States. China's bilateral trade surplus with the United States grew 67 percent to \$10.4 billion in 1990. This trend stems largely from a significant increase in Chinese exports -- especially clothing, toys, sporting goods, footwear, and consumer electronics -- to the United States. China's export capacity has benefitted greatly from foreign investment, particularly from Hong Kong and Taiwan, as production of labor intensive goods in those economies has become uncompetitive. Before being transferred to China, much of this production was targeted for export to the United States and this is still the case.

In 1990, China's exports to the United States rose by 27 percent, following a 41-percent expansion in 1989. These growth rates are significantly above those for China's global exports during the same period (18 percent in 1990 on top of 7 percent in 1989). (NOTE: There is a major discrepancy between China's calculation of its trade with the United States and U.S. official statistics. The difference is largely due to China's not counting its exports that are re-exported, probably with little value added, primarily through Hong Kong. Because the re-exporter adds little value, the United States considers these exports (i.e., U.S. imports) to be from China. The U.S. data will be used for the purposes of this analysis.)

China's imports from the United States rose 16 percent in 1989, but contracted by 16 percent in 1990 due to China's desire to limit overall imports. The increase in 1989 was greater than that for China's overall imports (7 percent), but the fall in 1990 was more pronounced than that for total imports (10 percent).

In the domestic economy, an austerity program was instituted in 1988 primarily to counter extreme inflationary pressures and overly rapid growth. The program also was designed to reduce China's overall trade deficit and build-up foreign exchange reserves. The government has, in fact, been especially successful in reimposing control over the external trade system, where reform had previously been the most far-reaching. This has enabled it to reverse the deficits in the external trade account. In addition, foreign exchange reserves have climbed by over \$10 billion, or 38 percent, to \$27.3 billion last year. Such a level is equal to eight months of imports.

In the first quarter of this year, according to China's data, the overall trade surplus was \$2.26 billion, an increase of 183 percent compared to the same period last year. Exports (fob basis) were up 24 percent, while imports grew by only 12 percent. China claimed to have a \$180 million trade deficit with the United States in this period.

U.S. data, however, reveal a \$1.7 billion deficit with China in the first 2 months of this year, a 30 percent increase over last year. This was our second largest trade deficit, behind that with Japan, and bigger than the total deficit with the four Asian NIEs. U.S. imports from China rose by 19 percent, while U.S. exports to China grew by only 2 percent during the period compared to last year.

o Foreign Exchange Allocation and External Trade System

The manner in which foreign exchange is allocated, along with import licenses and other market access barriers, is an important means by which China controls the external trade sector. These pervasive controls are symptomatic of the broader controls which characterize the command structure of the Chinese economy.

An import license is a prerequisite for obtaining a foreign exchange allocation for non-priority imports at the official exchange rate. The licenses are, hence, a primary means of controlling imports. However, even if a foreign trade company has obtained an appropriate import license, it may not be able to obtain a foreign currency allocation.

For priority imports, foreign exchange at the administered rate is allocated to foreign trade companies under the foreign exchange plans of the central, provincial, and local governments. The allocation decision, while not affecting exchange rates, does provide a second control not only on the value of imports, but also on the supplier of any particular product. This control, to the extent purchasers are directed away from U.S. suppliers to other suppliers, increases the U.S. bilateral trade deficit with China.

On the export side, China uses a number of licensing and other administrative means to influence exports. For example, China gives exporting firms priority access to raw materials, energy, and bank loans. An important element in China's export strategy is efforts to target sales to the U.S. market.

o Assessment

It is our assessment that the principal cause of China's bilateral trade surplus and external surpluses appears to be generalized and pervasive administrative controls over external trade, which inhibit imports, including from the United States, and promote exports, particularly to the United States, China's largest market.

The foreign exchange allocation system is a serious problem. Given the substantial reserves, there is no basis for this rationing except to restrict imports and control sources.

There is no clear evidence at this time of direct "manipulation" of the exchange rate itself within the meaning of the law. However, the recent devaluations, in conjunction with large external surpluses, raise concerns and indicate that a shift in exchange rate policy may be occurring aimed at reinforcing China's attempts to generate sizable external surpluses. Such a possibility is a matter of concern to the U.S. Government. In addition, the command nature of China's economy has allowed it to control the allocation of foreign exchange. This has been clearly done in a manner that impedes imports. There is, thus, a need to monitor this situation closely. Certainly, given the substantial real effective depreciation of the official rate of the yuan to date and China's reluctance to eliminate export subsidies and liberalize imports, no case can be made for further real effective depreciation.

There are a number of practical steps that China should consider taking to permit its exchange rate to reflect more fully market forces. First, China should make foreign exchange allocation automatically to companies which either have import licenses or are authorized to import without licenses, thus, removing foreign exchange allocation as another administrative barrier to imports. Second, China should liberalize foreign exchange transactions by permitting more transactions in the swap markets and the unofficial market. China should also eliminate other barriers to obtaining foreign exchange such as the requirement for explicit authorization.

These controls and the surpluses to which they contribute are a matter of concern for the United States Government. Treasury, therefore, intends to discuss China's foreign exchange policies with its authorities with a view to seeing China move toward a more market-oriented exchange rate determination and allocation system.

PART VII: CONCLUSIONS

Substantial changes have taken place in the world economy since the autumn report on International Economic and Exchange Rate Policy.

The Gulf War and its aftermath have highlighted the increasing interdependence of our nations and the world economy. Throughout the world, in Eastern Europe, Latin America, and many other developing countries, fundamental market-oriented reforms are being pursued with vigor.

At the same time, world economic growth has slowed markedly. Since last autumn, the IMF has marked down its growth projection for the major countries in 1991 by over a full percentage point to 1.3 percent. Several countries are experiencing recession.

There are encouraging signs of recovery in some quarters. Inflation is projected to decline significantly this year in the major countries, reflecting the reversal of the run-up in oil prices and the more moderate pace of economic activity. Interest rates have declined sharply in some countries, especially the United States. Current account imbalances have been further reduced, and the adjustment process is continuing in the major countries. Adjustment of structural fiscal deficits is underway in the United States, and this should strengthen national savings.

But a timely recovery of world economic activity is by no means certain. At this juncture, the hopeful signs of recovery have yet to be translated firmly into reality. Economic activity is slowing in those countries which until recently had been experiencing strong expansion. Furthermore, real interest rates remain persistently high in a number of other countries, in part reflecting the influence of regional and international transmission mechanisms. This confluence of factors is dampening investment and growth prospects.

Fostering an open, growing world economy is the most effective tool to meet the challenges of the changing world economy. Against the background of the increased interdependence of nations, countries must work collectively to achieve their common objectives of freedom and prosperity.

In these circumstances, G-7 economic policy coordination will need to play a central role in the world economy. Recognizing this basic reality, the Ministers and Governors of the G-7 countries, at their most recent meeting on April 28, 1991, reaffirmed their support for policy coordination as essential to achieving their common objectives.

In this context, they emphasized the importance of monetary and fiscal policies which provide the basis for lower real interest rates and a sustained global recovery with price stability. They reiterated the importance of policies aimed at increasing global savings and reaffirmed their commitment to cooperate closely on exchange markets. Also, all countries must maintain open markets to meet the challenges of the world economy, and the G-7 Ministers emphasized the importance of bringing the Uruguay Round to a successful conclusion.

Though the major industrial countries bear a special responsibility for the smooth functioning of the world economy, all countries have a role to play in promoting sustained growth with stable prices and adjustment of external imbalances. In this context, it was determined in the October 1988 and April 1989 reports that Taiwan and Korea, within the meaning of Section 3004 of the Omnibus Trade and Competitiveness Act of 1988, were "manipulating" their exchange rates against the U.S. dollar to prevent effective balance of payments adjustment or gain unfair competitive advantage in international trade. In October of 1989, it was concluded that there were no clear indications Taiwan was "manipulating" its currency, though there were continued indications of such "manipulation" by Korea. In April of 1990, it was concluded that there were no indications of currency "manipulation," within the meaning of the legislation, in either Taiwan or Korea.

This report has analyzed economic and exchange rate developments in Korea, Taiwan, and China.

Korea's external accounts have undergone substantial adjustment, following the substantial real appreciation of the won in 1988-89. For the first time since 1985, the current account fell into modest deficit in 1990 of \$2.1 billion (0.9 percent of GNP), which included a trade deficit of \$1.9 billion. The bilateral surplus with the United States fell to \$4.1 billion in 1990, down 38 percent from 1989. There continues to be no basis for concluding that Korea is directly "manipulating" its exchange rate for purposes of competitive gain, nor does it appear that Korea is using exchange controls to "manipulate" the exchange rate indirectly for several reasons. Korea's small external deficit will likely persist in 1991; its foreign reserves declined in the first quarter of 1991; and there is no evidence that the Bank of Korea is intervening directly in foreign exchange markets.

We remain seriously concerned, however, that pervasive Korean exchange and capital controls significantly constrain supply and demand in the currency market and distort the exchange rate. Liberalization of these controls is imperative to allow market forces to govern Korea's exchange rate and trade and investment flows, and to enhance the prospects for sustaining Korea's recent balance of payments adjustment. This is particularly important in view of the likelihood that current account surpluses will re-emerge in 1992, generating natural pressures for appreciation of the won.

Fundamental denials of national treatment for foreign financial institutions in Korea remain. The Korean Government has done little to address the need for broader liberalization of its tightly controlled financial markets, including deregulation of interest rates and elimination of credit allocation schemes. The Treasury Department views these issues as evidence that the Korean Government is unwilling in certain important areas to address the fundamental concerns of the United States. We will therefore continue to monitor developments in Korea's exchange rate and external adjustment, to press for liberalization of Korea's financial, capital, and exchange markets, and to seek improved treatment of U.S. financial institutions in Korea.

Taiwan's global current account surplus decreased by 4.6 percent in 1990 to \$10.9 billion, which included a 10 percent drop in its trade surplus to \$12.5 billion. Taiwan's bilateral trade surplus with the United States also fell by 14 percent to \$11.2 billion. With the decline in Taiwan's external surpluses and the continued liberalization of the exchange rate system, we have no evidence of direct exchange rate "manipulation" for purposes of unfair competitive gain. But Taiwan's persistent external surpluses remain too large, and their decline needs to be accelerated. Exchange rate appreciation will likely need to play a role in this process. In addition, Taiwan's exchange restrictions, while less pervasive than Korea's, impede the full operation of market forces in exchange rate determination. The Treasury Department will continue to monitor developments and to urge the authorities to liberalize exchange restrictions further.

China's current account, which had been in deficit in recent years, moved dramatically into a surplus of \$10.2 billion in 1990, 2.8 percent of GNP, with a trade surplus of \$9 billion. China's large and growing trade surplus with the United States rose 67 percent to \$10.4 billion in 1990. These developments chiefly reflect China's generalized and pervasive controls over the external sector, including both import restrictions and the allocation of foreign exchange. These controls, in conjunction with China's administrative determination of its exchange rate and sustained real effective depreciation in 1990, raise concerns and indicate a shift in policy may be occurring aimed at reinforcing China's attempts to generate significant external surpluses. The Treasury Department intends to discuss China's exchange policies, including exchange rates and exchange allocation, with its authorities with a view toward promoting a more market-oriented and less distorted exchange rate and exchange allocation system.

APPENDIXTABLES AND CHART

1. Economic Performance of Key Industrial Countries
2. Measurements of Dollar Movements Versus G-7 Currencies
3. Summary of U.S. Current Account
4. Summary of U.S. Capital Account Flows
5. Asian NIEs and China: Trade and Currency Changes
6. Chart: Real Trade-Weighted Exchange Rate Indices for the Dollar, Yen, and DM

TABLE 1
Economic Performance of
Major Industrial Countries

	<u>GNP 1/</u>			<u>Domestic Demand 1/</u>		
	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>
U.S.	2.5	1.0	0.2	1.9	0.5	-0.5
Japan	4.7	5.6	3.6	5.7	5.8	3.6
Germany	3.8	4.5	2.8	2.7	5.1	2.4
France	3.7	2.8	2.1	3.3	3.1	2.3
U.K.	1.8	0.6	-2.1	2.9	-0.1	-2.9
Italy	3.2	1.9	1.7	3.3	1.9	1.7
Canada	<u>3.0</u>	<u>0.9</u>	<u>-1.1</u>	<u>4.2</u>	<u>0.0</u>	<u>-1.3</u>
G-7 2/	3.1	2.6	1.3	3.1	2.4	0.9
	<u>Inflation 3/</u>			<u>Current Account 4/</u>		
	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>
U.S.	4.8	5.3	4.9	-2.1	-1.8	-0.7
Japan	2.3	3.1	4.0	2.0	1.2	1.3
Germany	2.8	2.7	3.5	4.6	2.7	0.6
France	3.5	3.4	3.2	-0.4	-0.6	-0.5
U.K.	7.8	9.5	6.0	-3.9	-2.4	-1.5
Italy	6.3	6.5	6.2	-1.2	-1.4	-1.5
Canada	<u>5.0</u>	<u>4.8</u>	<u>5.6</u>	<u>-2.6</u>	<u>-2.4</u>	<u>-1.7</u>
G-7 2/	4.5	5.0	4.6	-0.5	-0.6	-0.2

*Data for 1989 and 1990: national sources and International Monetary Fund. Forecasts for 1991: International Monetary Fund, World Economic Outlook (May 1991).

1/ Annual average rates in real terms.

2/ Average of individual country rates, weighted by GNP.

3/ Consumer prices; annual average.

4/ Calculated as percent of GNP; negative indicates deficit.

Table 2

Measurements of Dollar Movements (for key dates)
Versus G-7 Currencies
Percent Dollar Appreciation (+) or Depreciation (-)

As of April 12, 1991

Value of the Dollar in Terms of:	Since Dollar Peak 26-Feb-85 to Date	Since Plaza Accord 20-Sep-85 to Date	Since Louvre Accord 20-Feb-87 to Date	Over Last Year 12-Apr-90 to Date	Since Previous Report 12-Oct-90 to Date
Japanese yen	-48.2	-43.8	-11.7	-14.4	+5.2
German mark	-51.9	-41.5	-8.5	-0.2	+9.8
British sterling	-41.9	-23.8	-14.6	-8.2	+10.1
French franc	-46.7	-35.2	-7.1	+0.4	+10.9
Italian lira	-42.8	-35.4	-4.4	+0.8	+8.9
Canadian dollar	-18.1	-16.4	-13.4	-1.4	+0.4

Table 3
SUMMARY OF U.S. CURRENT ACCOUNT
(MILLIONS OF DOLLARS, S.A.)

	Quarters								Annual	
	89:1	89:2	89:3	89:4	90:1	90:2	90:3	90:4	1988	1989
Total Exports	88267	91111	89349	91738	96093	96585	96152	100456	320337	360465
Agricultural	10647	10677	9917	10225	10938	10317	9720	9374	38237	41466
NonAgricultural	77620	80434	79432	81513	85156	86268	86424	91082	282100	318999
Total Imports	116360	119333	119152	120484	122902	119810	125938	129317	447323	475329
Petroleum	10879	13519	13173	13322	15592	12164	15643	18709	39632	50893
Non-Petroleum	105481	105814	105979	107162	107310	107646	110295	110608	407691	424436
TRADE BALANCE	-28093	-28222	-29803	-28746	-26809	-23225	-29786	-28861	-126986	-114864
Partial Bal (Excl. Ag Exps & Pet Imps)	-27861	-25380	-26547	-25649	-22154	-21377	-23871	-19526	-125591	-105437
Net Services	4544	2579	5742	6685	-	-528	7403	10211	13131	19550
Invest. Income	465	-1957	17	561	2004	-990	2256	4265	1609	-914
Other Services	4079	4536	5725	6124	5925	5904	5147	5946	11522	20464
Total Transfers	-3555	-3006	-3530	-4631	-3440	-4422	-4099	-9112	-15005	-14722
Remits & Pensions	-999	-962	-909	-889	-1038	-921	-1106	-1037	-4262	-3759
Govt Grants	-2556	-2044	-2621	-3742	-2402	-501	-2993	-8075	-10743	-10963
NET INVISIBLES	989	-427	2212	2054	4489	492	3304	1099	-1874	4828
CURRENT ACCOUNT	-27104	-28649	-27591	-26692	-22320	-22733	-26482	-27762	-128860	-110036
										-99297

Source: Survey of Current Business, March 1991

Table 4
SUMMARY OF U. S. CAPITAL ACCOUNT FLOWS
(MILLIONS OF DOLLARS, S. A.)

	Quarters								Annual	
	89:1	89:2	89:3	89:4	90:1	90:2	90:3	90:4	1988	1989
US Reserve Assets (Inc(-)Decr(+))	-4000	-12095	-5996	-3202	-3177	371	1739	-1091	-3913	-25293
Other Govt Assets	962	-303	574	-47	-659	-808	-360	4797	2968	1186
Foreign Official Assets	7797	-4961	13003	-7016	-8203	5541	13588	19851	39515	8023
Industrial	1646	-7021	7540	-2253	-7500	6413	13092	12224	30306	-88
OPEC	7100	460	4532	-1379	2953	208	-1600	341	-2996	10713
Other	-949	1600	931	-3384	-3656	-1080	2096	7286	12205	-1802
Banks, net:	-6100	6023	6576	4016	20089	-8742	14102	-4847	13913	10515
Claims	-23586	26829	-21269	-32658	52353	-13639	-13489	-24409	-56322	-50684
Liabilities	17486	-20806	27845	36674	-32264	4891	27591	19562	70235	61159
Securities, net	15992	5769	13465	12355	-5945	-4743	-2581	-8376	38747	47581
Foreign Securities	-2062	-6144	9653	-4109	-7496	-11247	-1223	-6819	-7845	-21938
U.S. Treasury Securities	9223	2339	12618	5671	-835	3614	312	-1947	20239	29951
Other U.S. Securities	8731	9574	10470	10793	2486	2890	-1670	390	26353	39568
U.S. Direct Invest. abroad	-6024	-7284	-9639	-8776	-9318	-4821	-19186	-3045	-18218	-31723
Reinvested Earnings	-6165	-5342	-6694	-4215	-5764	-3575	-6341	-5971	-12615	-22416
Equity & Inter-co. Debt	141	-1942	-2945	-4561	-3554	-1246	-12845	2926	-3603	-9307
For. Direct Invest. in U.S.	21348	17055	12375	21466	5537	7236	11885	1050	58435	72244
Reinvested Earnings	-2438	1824	1204	-678	-2138	-826	-2106	-4871	6561	-9941
Equity & Inter-co. Debt	23786	15231	11171	22144	7675	8062	13991	5921	51874	72332
Other U.S.-Corp., net	5568	-2791	-298	1779	1492	-233	9050	n.a.	3817	4258
Claims	1851	-2384	1877	47	1202	-1550	625	n.a.	-2847	1391
Liabilities	3717	-407	-2175	1732	290	1317	4425	n.a.	6664	2867
NET CAPITAL FLOWS	35543	1413	30060	20575	-84	-6199	24237	8339	137264	87591
Statistical Disc.	-8439	27236	-2469	6117	22404	28932	2244	19424	-8403	22445
TOTAL	27104	28649	27591	26692	22320	22733	26481	27763	128861	110036

Source: Survey of Current Business, March 1991

TABLE 5

ASIAN NIES AND CHINA: TRADE AND CURRENCY CHANGES

Cumulative Change against US\$ as of April 12, 1991

from:	(Plaza)		(Report)				Rate on 4/12/91
	9/20/85	end-86	end-87	10/14/88	end-89	end-90	
HK\$	0.31%	0.00%	-0.39%	0.30%	0.19%	0.12%	HK\$ 7.79
Won	23.24%	18.67%	9.16%	-2.14%	-6.49%	-1.30%	W 725.80
Singapore\$	25.23%	23.44%	13.45%	14.97%	8.08%	-1.11%	S\$ 1.76
NT\$	48.55%	30.15%	4.67%	5.95%	-4.07%	-0.62%	NT\$ 27.28
Yen	77.76%	17.16%	-9.26%	-7.19%	5.45%	-0.42%	Y 136.22
DM	71.39%	15.16%	5.18%	7.15%	0.42%	-11.18%	DM 1.68
Yuan	-43.73%	-29.43%	-29.43%	-29.43%	-10.25%	-1.01%	Yuan 5.27

* [-] signifies depreciation against the U.S. dollar.

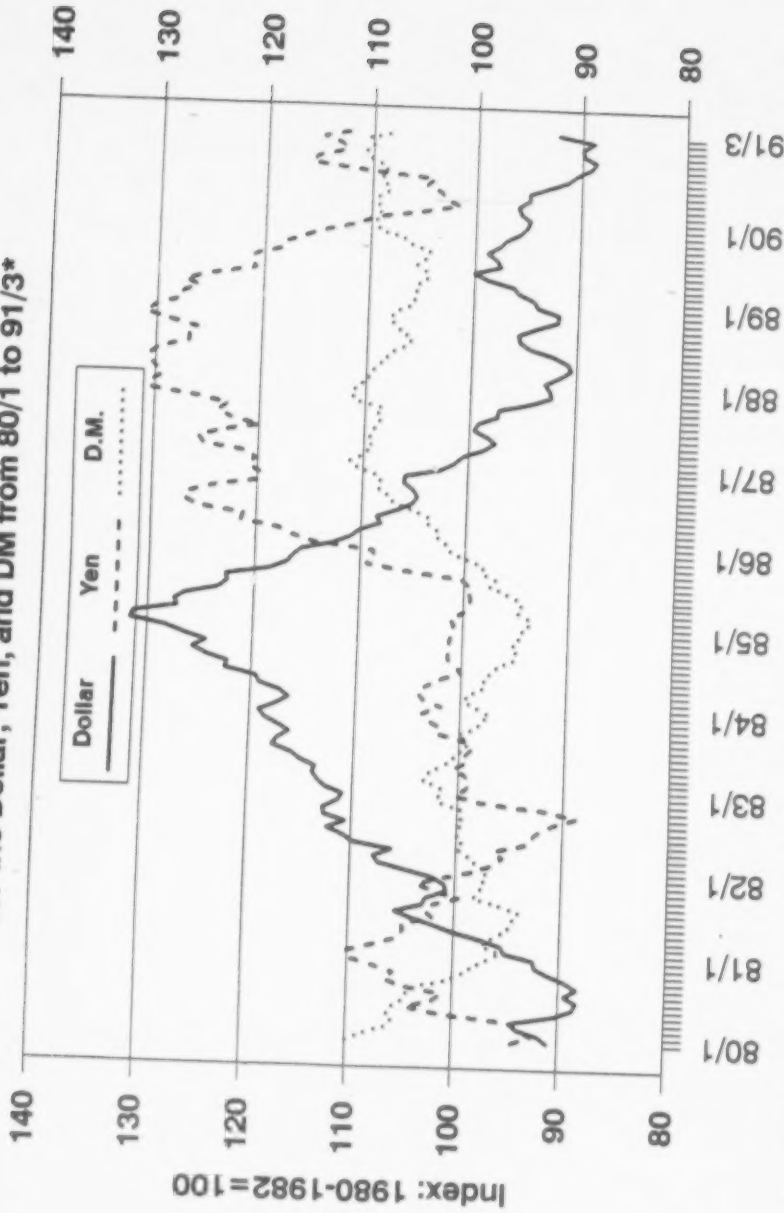
U.S. Trade Balance with Asian NIEs and China [1]
(U.S. \$ Billions)

	1985	1986	1987	1988	1989	1990	1-2/90	1-2/91	% Change
Hong Kong	-5.6	-5.9	-5.9	-4.6	-3.4	-2.6	-0.4	-0.1	-72.6%
Korea	-4.1	-6.4	-8.9	-8.9	-6.3	-4.1	-0.7	0.0	-101.9%
Singapore	-0.8	-1.3	-2.1	-2.2	-1.6	-1.8	-0.3	0.1	-128.5%
Taiwan	-11.7	-14.3	-17.2	-12.6	-13.0	-11.2	-1.8	-1.5	-12.2%
TOTAL NIEs	-22.1	-27.8	-34.1	-28.2	-24.3	-19.7	-3.2	-1.6	-50.9%
China	0	-1.7	-2.8	-3.5	-6.2	-10.4	-1.3	-1.7	29.7%
Total U.S.									
Trade Bal.	-130.1	-162.7	-152.1	-118.5	-108.6	-101.0	-18.0	-11.5	-28.3%
NIEs % Total U.S.									
Trade Bal.	17%	18%	22%	24%	22%	20%	20%	14%	
China + NIEs									
% Total U.S.	17%	19%	24%	27%	28%	30%	28%	28%	

[1] U.S. customs value data, not seasonally adjusted.

Totals may not equal sum of components due to rounding.

Real Trade-weighted Exchange Rate Indices
for the Dollar, Yen, and DM from 80/1 to 91/3*



*Source: JP Morgan; 1980 trade weights (18 industrial and 22 developing countries; 1980-82 = 100.

Senator SARBANES. Thank you very much, Mr. Secretary.

We've been joined by the chairman of the full committee, Senator Riegle. And I'll turn to him now for any opening statement he wishes to make.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. Thank you very much, Senator Sarbanes. Let me commend you on your initiative and leadership on this important set of issues, and this hearing today.

One of the important provisions that this committee developed and put into the 1988 Omnibus Trade Act, of course, requires the Secretary to submit to the committee each October 15 an annual report on International Economic Policy Coordination, including exchange rate policy. That provision also requires that such reports be updated each 6 months.

The reason we developed that provision is due to the fact that, in the early 1980's, the Reagan administration permitted the value of the dollar to rise and remain at a very high level for an extended period of time with very severe consequences for our balance of trade.

We went from a creditor nation to a debtor nation for the first time since the early 1900's. We're on our way now to a \$1 trillion international debt. That's about \$800 billion at the present time.

So, these semiannual reports and hearings are designed to increase the accountability of the executive branch and ensure that having a competitive exchange rate becomes an important national economic goal, and one that is clearly in focus.

It was also clear when we passed the 1988 trade bill that certain countries were manipulating their exchange rates in order to gain a competitive trade advantage against the United States. Such actions made it easier for those countries to sell their goods here, and much more difficult for American companies to sell our goods—American goods—in those foreign countries.

So, we asked Treasury to identify currency manipulating countries and to institute bilateral negotiations to stop these practices.

In the past, in particular, Taiwan and Korea, were identified as currency manipulators. Mr. Mulford has made some comment about them today. But, one item that makes the Treasury's report particularly timely now is its focus on our growing trade imbalance with China.

In 1990, China's trade surplus with the United States reached \$10.4 billion. The Treasury contends that is due to the fact that China has utilized "pervasive administrative controls over external trade and payments" to inhibit imports from the United States and to promote its exports to this country.

Last year, China sold \$15.8 billion in goods to the United States. Yet, our exporters sold only \$5.4 billion in American goods to the Chinese.

I must say I can't understand why the President continues to insist that we give China most-favored-nation trading status when that country uses foreign exchange controls to gain a trade advantage with us. A multibillion dollar trade advantage. The effect of

this practice is to have American workers surrender their jobs to Chinese workers. And that's exactly what's going on now.

I might just say parenthetically we're being asked to, in effect, accept and ratify the same thing over in the area of the United States-Mexico proposed free trade agreement where, in my view, there's a great danger because that's a way to accelerate the export of American jobs to another country, in that case, Mexico.

But, clearly, that is what is going on today with respect to China. Now, the President insists that despite the damage that's being done to the U.S. economy and to workers in this country who can't find work, that we've got to give the Chinese this most-favored-nation trading status because of "the big picture."

Well, I'm not sure I understand exactly what this "big picture" is, but if it doesn't start with a very careful assessment of what's going on in the economy of the United States, what's going on here at home, how strong we are here, whether there's enough work to go around in this country, then I think it's a picture that is not helpful to us.

I think too much time, quite frankly, Mr. Chairman, is being spent on foreign policy, as important as that may be, and not enough time is being spent on domestic policy.

Clearly, this Government has a foreign policy. I don't think there is a domestic policy worth talking about in terms of a serious focus on job strength and on the economic well-being of this country.

We see it in the efforts to not combat the recession directly. We talked in this committee the other day about the lack of action even on something as basic as the extended unemployment compensation benefits. We have a situation today where there is an over \$6 billion surplus in the unemployment compensation fund, paid in by workers who, in many cases, are now unemployed and need to draw those benefits, and they can't draw the benefits because there is no extended benefit program in place, such as we've had in other recessions.

When the unemployed exhaust their 26 weeks of unemployment compensation, they're out of luck. And if they can't find a job, as most can't, then they are in a situation where their life deteriorates rapidly. Many of them are losing their homes, losing their cars and having other difficulties arise. Yet at the same time, we see these bloated trade balances growing with countries like China and not enough is being done to deal with it.

So, the notion that the United States should continue to look the other way while these economic effects are accumulating in the United States, I think, is wrong. As much as I like this President, I think it's important that he start to pay attention to the economic realities here in America.

We need a job strategy for America. Not just a job strategy for China and a job strategy for Mexico and a job strategy for Kuwait and a job strategy for every other country in the world—but no job strategy for America.

Our strength has to come from people working here and, today, many are unable to find work. There was a case the other day in a small town in Massachusetts. A Pizza Hut restaurant opened. It advertised 11 job vacancies at the minimum wage, or just slightly above; 1,100 people show up trying to get one of those jobs.

And that's partly because we're having our jobs going overseas because of the failure to deal strongly and directly with these foreign countries.

I know the President has a strong feeling for China. He was the Envoy to China and he understands that country better than most do because of his relationship at that time.

But that is no excuse for or no justification for looking the other way on either the human rights abuses in China, which are real and pervasive and manifest, or the economic abuses that are coming out of the hides of American workers.

It's time that we had an administration that gets tough on these issues and goes to bat for American workers. They're the ones that have been forgotten in all this foreign policy and all of this "big picture."

I just want to say one other thing and then I'll close, Mr. Chairman. I appreciate your courtesy in giving me the time to make my statement.

I've watched Mr. Mulford work on these issues and I appreciate the effort that he's been making. He's been one of the people in the Government that has shown some concern and effort in this area and has drawn attention to it.

And so, while I express some very strong feelings here, I, at the same time, appreciate the efforts that I think you have made within the policy latitude that I feel you have to work with.

However, there's only so much one person can do if the policies are not solid at the top. And I don't think they are solid at the top. I think they're designed to help others, and, in effect, they're hurting our own people, and that's just not right.

Thank you, Mr. Chairman.

Senator SARBANES. Thank you very much, Chairman Riegle.

Mr. Secretary, as you can obviously sense from the chairman's comments, there's a deepening concern in the Congress, particularly at a time of a recession which we do not regard as short and shallow—we think we're into a serious turndown, by evidence that other countries are continuing to, in effect, play off the system to their advantage and to our disadvantage.

The reason we get these reports is to try to make sure that things are working on a two-way street. And there's some very disturbing elements in this report, which I hope now to go into with you to some degree.

But, I share Chairman Riegle's view that we've got to take a much stronger position. Our people are, in effect, being unfairly taken advantage of through a manipulation of the rules of international trade and commerce.

You've been effective in the past in trying to address that issue and, of course, we need to address it now.

Let me just turn to China very specifically, the People's Republic of China. First of all, you report China's trade surplus for 1990 was \$9 billion. And I used a figure of \$12 billion.

Our figure comes from the IMF's international financial statistics, May 1991, which shows, in 1990, China, with exports of \$56.4 billion and imports of \$44.3 billion, for a surplus of \$12.1 billion.

Do you have any explanation for the discrepancy in the figure?

Mr. MULFORD. I don't offhand have an explanation for the figure, but I can give you something in writing on that, unless somebody can provide me with something here that explains the discrepancy.

But, I can't answer that, Mr. Chairman.

Senator SARBANES. In any event, if we were to use your figure of a \$9 billion world surplus, then all of that, more than that, was in the surplus with the United States.

Is that correct? Which was \$10.4 billion?

Mr. MULFORD. That's correct.

Senator SARBANES. My figure indicates that China, in 2 years' time, between 1988 and 1990, has tripled its trade surplus with the United States, that, in 1988, China—well, first, in 1985, it was in balance. It was zero.

By 1988, it was \$3.5 billion. It jumped to \$6.2 billion in 1989. And now has jumped to \$10.4 billion in 1990. So that, in 2 years' time, it has tripled from \$3.5 billion to \$10.4 billion.

Is that correct?

Mr. MULFORD. That's correct.

Senator SARBANES. Well, then, is it also correct, do I read your table on page 24 to indicate that China succeeded in lowering its real exchange rate by 25 percent last year, in 1 year's time?

Mr. MULFORD. That's right. In 1990 alone, they depreciated their currency by 25 percent.

Senator SARBANES. Well, I guess there's a concern here that a double standard is being applied to China. That's certainly the response to the President's request for MFN. I'm very frank to say that I think that these figures will become one dimension. In judging MFN, why should we extend the most-favored-nation treatment and the trading arrangement when the trading arrangement is being abused in the currency area?

Would you agree that it's clear that China's managed exchange rate has affected its trade balance?

Mr. MULFORD. I think that's a harder judgment to come to. I'm sure that it has had some influence. Perhaps I could take a moment in trying to make a general point here, Mr. Chairman.

First of all, we have had some success with Korea and Taiwan. We've had talks going on with both of those countries, and it's been over a period of years and we've seen some improvement.

Senator SARBANES. And I wanted to echo Chairman Riegle's observation that it is at least my perception that you've been a very effective advocate negotiator or representer for the United States in those talks.

Mr. MULFORD. Thank you very much, Mr. Chairman. I do appreciate that very much.

In the case of China, the phenomenon that we are seeing is not very old. That is to say, it's arisen in the past couple of years. The last year or so has been a time of great sensitivity and not particularly close contact between the United States and China. We have watched very carefully what has been happening.

Between 1985-89, there was no clear pattern of exchange rate depreciation in China and we reported that in our previous reports. And as we have watched, the exchange rate situation changed—in other words, there's been two important devaluations, one in 1989 and one in 1990. The 1989 one was done in conjunction with the

IMF, which had actually recommended it. But, it had done so on the basis that it would be associated with a reduction of import controls and export subsidies.

Now, in fact, that never happened. The Chinese did not carry out those policies. They didn't implement their side of the bargain. So, that devaluation took place in a sense, you could say, with a sense of legitimacy about it, although after the fact, it's turned out not to have been fully fulfilled.

The second devaluation, in 1990, 25 percent, that really did concern us and cause us to look very carefully. But, what we see is an exchange market that cannot be analyzed, at least from this distance and without more work in a way that produces clear evidence of manipulation of the currency of the type that we saw earlier in Korea and Taiwan. It seems that it is the combination of export policies and import policies, policies which block imports and policies which advance or encourage exports, together with the currency setup which is a dual level setup of private and off-market transactions, that somehow seems to operate to help produce this surplus.

And I have to be frank with you, Mr. Chairman. At this point, I'm not sure that we fully understand exactly how all this comes together to produce this result. That is why we have suggested in the report that it is now time, we think, to engage with the Chinese Government in the process of, first of all, learning exactly what goes on and why, then engaging them in negotiation.

So that's how I characterize the situation at the moment.

Senator SARBANES. I have some concern that because the Chinese economy is more of a command economy than either Taiwan or Korea, that you're then not able to make as clear a judgment just on the exchange rate. But, the combination of what they're doing on the exchange rate and this—what you call generalized and pervasive administrative controls over external trade—that's your very language in the report—is enabling them to achieve the same result, in a sense, almost a worse result than what we confronted in the instance of Taiwan or Korea. The law actually doesn't require that you find, as I read it, that the exchange rate be a principal cause.

You state here, "The principal cause is the administrative arrangement." I don't think that is in the law. The law requires material global current accounts surplus and a significant bilateral trade surplus with the United States. And China would seem now to meet both of those requirements. They brought their global account into a significant positive balance and, of course, they have the trade balance with the United States, is now at \$10.4 billion. And we're told there are reasonable estimates that it may go as high as \$15 billion this year.

Do you expect it to go up this year even further?

Mr. MULFORD. Well, the first couple of months of this year have seen, I believe, a 30-percent rise, and it's been disturbing to us that it's going up as quick as it is. Yes, I think it is going up.

I don't disagree with your analysis, but I would say one thing, for example. When you look at the exchange rate regime in China, you see a curious fact. They have the so-called swap centers and the black market, which are supposed to be market-sensitive exchange

rate operations. They have an exchange rate value there that is, in fact, weaker than the administered rate, which would suggest that maybe the administered rate is overvalued.

So it's these quirks and these difficulties, I think, that make it hard for us at this distance and with so little direct contact to come to the kind of conclusions that are clear enough to give you the comfort that you are seeking.

I think our solution would be to get to work on this problem and figure out what to do and then begin to negotiate with the Chinese.

Senator SARBANES. Well, I'm going to yield now to Senator Riegle. But, just let me make this observation.

We are headed for a major issue in the Congress on the extension of most-favored-nation treatment. The President now has indicated that he wishes to extend it yet again despite the Chinese performance with respect to human rights, the export of arms on the part of China, this growing trade deficit, which is moving very rapidly. I mean, it was at \$3.5 billion in 1988; it was at \$10.4 billion last year, and it's expected to go to conceivably even \$15 billion this year, which would be four times what it was 3 years ago.

In part, achieved through, it appears, currency manipulation and, in part, achieved through administrative controls, generalized and pervasive controls.

Now, it really challenges one to find the basis on which to provide continued MFN in the light of these practices. And, of course, that's going to be a major issue before the Congress in the near future, probably too near a future for you to achieve anything on the exchange front. We're going to have to deal with what's been done there as a reality on the basis of which we'll have to make our judgments.

Senator Riegle.

Senator RIEGLE. Thank you, Senator Sarbanes.

Mr. Mulford, am I right in recollecting that when the vote was taken in the U.N. in the Security Council on authorizing the war effort in the Persian Gulf, the Chinese abstained from voting?

Mr. MULFORD. I think that is correct.

Senator RIEGLE. I think you'll find that's right. There was a question leading up to that vote as to how the Chinese would vote because had they could have exercised their veto right and stopped that plan.

But they didn't vote that way; they abstained, which meant that they allowed the effort to go forward.

Mr. MULFORD. They did not exercise their veto right.

Senator RIEGLE. I wondered at the time about what they might do if there was any sort of understanding or implied understanding that, in exchange for supporting this country's policy in the U.N., we might be more accommodating to them on other things, like trade balances and things of that sort.

But, in today's Washington Post, it's quoting the President as follows:

"Bush said his desire to renew China's trade status came from looking 'at the big picture,' which I cited earlier, adding, quote; 'I look at the support we got from China in Desert Storm.'"

I want to repeat it.

"I look at the support we got from China in Desert Storm."

Now, insofar as I know, there were no Chinese forces actually involved. I take it that the support he refers to is this favorable abstention on this key vote in the Security Council at the United Nations.

Let me tell you what my belief is. I think these things start to reflect a pattern. They start to reflect a pattern where, in effect, we make accommodations with other countries to get their support on U.N. votes or to get their support in some other international foreign policy endeavor and, the accommodation, whether spoken or unspoken, is that we make economic concessions favorable to those countries.

Now, if you look at other participants in Desert Storm, you'll find that other people who ended up deciding to help receive very material economic benefits from the United States for doing so.

I mean, very major economic concessions were granted in one form or another—forgiveness of debt, equipment grants, and things of that kind—in the same time period.

And there is something of a pattern here that's very disturbing to me because I think what is happening here is that, in an effort to try to advance what may be seen as foreign policy objectives, we're paying a very severe domestic economic policy price, which is coming right out of the heart of the American economy. I think it's coming right out of our job base.

People around the country that are wondering why economic conditions are so tough, and so tough in their own individual situations, I think have to understand that these events bear some relationship to one another.

I can't imagine that we would be giving this kind of easy treatment, if you will, to the Chinese, especially on the most-favored-nation issue when, in fact, their trade surplus is rising so sharply, it's displacing American workers. We know there's an element of manipulation in it.

And if it's not in exchange for support on sensitive issues in the United Nations, what is the rationale?

What is the purpose?

I'll tell you. On its face, and even going back to this phrase that the President himself used, I look at the support we got from China in Desert Storm. He obviously sees a relationship in his own mind. So I certainly see a relationship here that's disturbing to me.

I would hope that this Government would not engage in a situation where, in order to secure the support of other countries, even on important issues in the United Nations, that we will allow a kind of economic exploitation to go on that's hurtful to this country.

I think it's wrong to have even the appearance of any kind of a bargain of that sort, let alone the actual fact of it. The juxtaposition is very, very troubling to me. I think, in large measure, it speaks for itself.

Mr. MULFORD. May I just make a brief response to that, Senator?

The President made his views known yesterday. He also indicated that the final decision was still under review. You're right, he did talk about the big picture. He indicated that things are better in and with China than they were in the 1970's. He indicated that China had been helpful in Desert Storm.

And he made what I think is a very important point:

That we do not want to isolate China.

Now, a few minutes ago, I said that we'd made some progress with Korea and Taiwan when a problem appeared. And I think it's certainly a very sensible approach if you are going to try to engage a nation, a nation which is extremely sensitive, as we know, on many of these issues, in talks on trade and talks on issues of the type contained in this report, exchange rates and so on. I think it's important to try to do that on a basis where we can be successful and figure out, as I said, what the problems really are and try to negotiate to get those corrected.

And, perhaps within the period of a year or two, we will make the same kind of significant progress we made with the other countries.

So, withdrawing MFN, which is a 1 year annual review process, I'm sure the President would believe is not the way to go considering the big picture issues that he cited at a moment when, in addition, you're engaged in negotiations to try to accomplish something to remedy the problem.

So I think the President's view would probably be, in addition to what he said, that, yes, we have problems. We should get on them. We should negotiate them. We should solve them, and so on. But, we should not do so in an atmosphere where we've taken a highly aggressive and offensive action.

I think withdrawal of MFN would be regarded by the Chinese as that sort of action. That's something that you can do in the future but, right now, it is a time when that's a matter of very considerable sensitivity. I don't want to prejudge the decision; I'm just saying that, insofar as the issues in this report are concerned, I personally think that it will be easier to meet with and negotiate positively and get some constructive results from the Chinese Government in a favorable atmosphere.

And since we both want to try to fix the problem, that ought perhaps to be our approach.

Senator RIEGLE. Could I just ask one other question? When we were lobbying the Chinese to abstain on that U.N. vote, as clearly we were, do you know if MFN was mentioned at all in any of those discussions?

Mr. MULFORD. I don't know the answer to that.

Senator RIEGLE. You don't know one way or the other?

Mr. MULFORD. I was not present at the meetings and I wasn't involved in the paper flow in that process. I just don't know the answer to that.

Senator SARBANES. I would observe that the President met, contrary to the previous policy, with the Chinese Foreign Minister, either just after or before that vote. Received him at the White House.

Do you recall that?

Mr. MULFORD. I do think I recall that, although I'm not absolutely certain.

Senator SARBANES. Now, Mr. Secretary, while Senator Riegle is still here, of course, it's always a sensitive matter, this issue. I mean, every time this MFN question comes up, everyone says this is very sensitive. We're going to do better if we continue to extend

MFN. And we continue to extend it; and we continue to get abused is what happens.

Now, at some point, you've got to start making tougher judgments, I think. Let me take a little picture view, not a big picture view. I want to take a little picture view, and I want to take it right out of the Treasury report. And I want to take it right out of the movement of exports and imports.

I'm looking on page 26 of your report.

Mr. MULFORD. Let me say that Treasury is often accused of taking a little view. [Laughter.]

Senator SARBANES. China's imports from the United States rose 16 percent in 1989, but contracted by 16 percent in 1990 due to China's desire to limit overall imports.

Now, at the same time, their exports to the United States jumped 41 percent in 1989 and 27 percent in 1990. You then go on to point out that the increase of their imports from the United States in 1989 of 16 percent was greater than their overall imports.

But, then the fall was much greater the following year, down 16 percent. And you also note further on that U.S. imports from China rose by 19 percent. This is in the first 2 months of this year. And our exports grew by only 2 percent.

Now, what you have is exports to the United States in 2 years and then the period we have for this year have gone up 41 percent, 27 percent, 19 percent. Exports to the United States and imports from the United States went up 16 percent. They went down 16 percent. Now, they're up 2 percent. Just about the same.

Now, something's going on here. I mean, I can't believe that the simple working of natural economic forces is producing these results.

You don't believe that, do you?

Mr. MULFORD. We haven't said that either.

Senator SARBANES. You don't believe that either?

Mr. MULFORD. No, we don't.

Senator SARBANES. Now, what's at work? Currency manipulation? Administrative controls? Manipulation of the currency exchange rates? Allocation controls? A whole regime of—I take it they're still subsidizing exports, unlike the agreement they arrived at with the IMF at the time they did the earlier devaluation. They're placing impediments in the way of American exports into China.

This whole arrangement is being manipulated. I mean, if we extend the most-favored-nation arrangement on the premise, I assume, that it's going to be in the context of free and fair trade.

The rules are going to be adhered to and there's going to be a reciprocal arrangement. And it's going to be a two-way street. That's clearly not happening here.

Is that correct?

Mr. MULFORD. I think that's right. I think, as I said before, the last couple of years have produced some very strange and hard to understand developments.

I would not say that our judgment is at the moment that the exchange rate is "manipulated." But, I also have to say I don't think we understand very well exactly how that exchange rate system

works and how it impacts the functioning of the economic accounts, that is to say, the trade and current accounts.

We need to know more about it. We don't like what we see, and we are clear in our mind that there seems to be some association of import policies, export policies, exchange rate policies, and so on, that somehow conspire together to produce a highly unfavorable result from our standpoint.

We accept that view. We have advanced that view in this document. We now think that it's time to engage the Chinese in negotiations on these issues. We have not done so up to now, for reasons that I think everybody understands. We now have another year of evidence, and it's time for us to make a beginning in these negotiations. And we intend to do that.

The question then becomes I think what's the way to get a good result out of those negotiations. I think that's an issue on which you can have a lot of different ideas and opinions. And I think, you know, there will be a lot of different ideas and opinions on that issue before the MFN decision is made.

But, it's certainly clear that you want to have a positive negotiation in which you obtain results because we did obtain results from Taiwan and Korea without, in a sense, using nuclear weapons against them.

We initiated negotiations. We used what leverage we could find. And we had reasonable success. So, perhaps we can do that again.

Senator SARBANES. Is it your perception that the economic relationship with China, with the PRC, more so than with most countries, has been governed not by economic criteria but that there's a heavy dosage of political criteria that enters into the relationship?

Mr. MULFORD. I think that's right.

Senator SARBANES. More so than with most other countries?

Mr. MULFORD. I don't know that I could make that judgment about most other countries. There's a lot of politics everywhere. But, you're certainly right in your observation.

Senator SARBANES. I want to turn now to the higher dollar. The U.S. balance of trade showed improvement in 1988 and 1989 and 1990, moving from a trade deficit of \$150 billion in 1988 to just under \$100 billion in February of this year.

That's still very high. And, of course, these trade deficits we have run have resulted in the United States now being a debtor rather than a creditor nation internationally.

I think most agree that an important cause of this improved trade performance was the dramatic decline in the value of the dollar that took place in 1986 and 1987, after the Plaza accords in, as I recall, the fall of 1985.

The value of the dollar continued to decline in 1990, partly accounting for the strong performance of U.S. exports in the second half of the year, which of course provided a growth element in economic development.

Now, in February and March of this year, the value of the dollar increased by 20 percent against the mark, 20 percent. And 10 percent against the yen. And has remained at approximately those levels in April and May.

There's growing concern, obviously, that if the dollar remains at its present levels, it runs the risk of weakening export growth later

this year or early next year, which could have the result of either prolonging the current recession or weakening any recovery that might take place.

Was the value of the dollar a topic of discussion in the G-7 meeting?

Mr. MULFORD. Yes. It's always a topic of discussion, exchange rates in general.

Senator SARBANES. Was any conclusion reached with respect to the value of the dollar? And, furthermore, what was the view taken of this rapid rise, and significant rise in the value of the dollar during the course of this year?

Mr. MULFORD. Well, at both meetings of the G-7 Ministers, one in January and then one more recently at the time of the spring meetings of the IMF and the World Bank, the view about currencies was that they were in the roughly appropriate levels and more or less in line with fundamentals.

There were currency movements between the two meetings, and the currency markets, of course, were affected by the Gulf crisis and its various unfolding elements; from time to time, the dollar would strengthen against some developments. At other times, for example, immediately after the war ended, economic factors seemed to come to the fore and the dollar weakened a bit.

But I would say, as to the competitive position of the United States, the movement of the dollar in a sort of a spike down to an historic low, for example, against the DM, which occurred this year, was relatively brief.

And, although it's come up off that base by a certain percentage that appears to be quite high and although we, ourselves, were concerned with the speed with which it seemed to move, I think you'd have to say that the United States, if you're taking the long view, has not been made uncompetitive by these movements. After all, the strong export performance of this country, the improvement in our international accounts which has been significant, is the result of factors, among them exchange rates, but the exchange rate factors would be those of 9 months to 1½ years ago, when the rates were not all that different than they are now.

I think, at this level, our view is that we're still competitive and we would not expect to see deterioration of our competitive position because of the recent movement of the dollar.

Senator SARBANES. So, it's your view that no action should be taken of any significant sort to affect the value of the dollar?

Mr. MULFORD. No, not at this time.

Senator SARBANES. How much more movement would have to happen before you changed that view?

Mr. MULFORD. That's a question, Mr. Chairman, that is, in a way, speculative, if I could say, and I just don't feel that I could or should answer that question.

Senator SARBANES. Do you feel you're getting close to the point?

Mr. MULFORD. I think that one can simply stand with what I've said so far. I think it's unwise to get too micro in one's comments about specific levels of exchange rates.

Senator SARBANES. There's been some evidence that the export sector is slowing down as a source of growth to the economy.

Is that correct?

Mr. MULFORD. I don't think that's correct. I think we've had a good, solid performance and we continue to have an 8- to 10-percent increase in our exports. That, of course, is a lower level of increase than earlier in the adjustment. But, then, again, earlier in the adjustment, we were coming off a highly uncompetitive situation.

So, you would expect the rebound in the early phase of that adjustment to be greater. We had a 25- to 30-percent increase in exports for a while. But, the export increase we've seen in recent times is, though smaller, very steady, very solid and probably will be of considerable duration.

We have already seen the trade account imbalance improved to a level of \$100 billion, even though we have adverse oil price effects during that period. Our projection is that, as you've seen in the report, that we will see further improvement in the trade account and further, rather dramatic, improvement in the current account, down perhaps to \$75 billion, or to a level, if you take into account the Desert Storm payments, as low as \$35 to \$40 billion.

So these are major improvements. The external imbalances of the United States have improved very considerably and we think we will stay competitive at these levels.

Senator SARBANES. The reports out of the G-7 meeting were that the United States strongly urged the other member countries to reduce interest rates as a spur to world economic growth.

Apparently, we were concerned, one, about the weakness in our own economy; and also that the economies of other leading industrial countries are either slowing down or flat, or even in recession in some instances, raising the specter of significant slowdown in world economic growth.

Is that an accurate report of the U.S. view?

Mr. MULFORD. I think it's a somewhat narrow view of what we tried to project. Let me just take a minute on this because the view has been rather narrowly projected in the press.

When the Secretary went to Europe in April and visited widely, and also in the Middle East, we had a broad discussion with our counterparts about the global economic situation. We have gone through a period of G-7 coordination with considerable success, where growth and inflation, as well as external imbalance reduction were the priorities. And there was good progress on that.

We saw a successful performance, convergence of economic performance, on a positive basis over a period of years and we accomplished changes that were necessary.

We are now in a situation where the fundamental economic patterns have changed, and we have a diverging pattern. Five of the seven G-7 countries are either flat or in recession; two are growing positively, but at declining rates of growth.

What we sought to do is to shift the dialog from one where we have been concerned about the problems I mentioned to one where we place a somewhat greater priority on the need to maintain global growth.

Now, we think our economy is in the process of turning around and we will see recovery. There's some dispute as to exactly when and how strong it will be.

But, for the rest of the world, some countries growing at low rates and other countries showing some weakness in their growth, we are concerned about the global growth pattern because the kinds of problems that we face in the world are all more difficult to solve if there is a lack of growth.

So we think it's important to shift the focus a bit with a wide variety of policy considerations, among them, for example, improving trade access, completing the Uruguay Round, looking into global savings—which have been declining for a number of years. And among those issues was the question of high real interest rates.

And we made the point that, in Europe, real interest rates are at record levels. And we expressed concern about that and tried to engage people in that discussion.

There wasn't a full consensus. We think we made some progress. And I'd like to just cite to you, Mr. Chairman, since that meeting, there have been some important changes in interest rates around the world.

On April 30, the United States reduced its discount rate from 6 percent to 5.5 percent. On May 12, Italy reduced its discount from 12.5 to 11.5 percent. Australia has reduced their discount rate by 1 percent. And, this morning, Spain reduced their interest rates by $\frac{3}{4}$ of 1 percent. And that's very significant because their currency has been at the top of the exchange rate mechanism system.

So, we've seen some shift. And this is the issue.

We didn't just have a single dimensional discussion of interest rates. That's my point. And we were not expressing a lack of concern either about the need to continue a vigilant policy on inflation. We were clear that we were expressing a continuing vigilance on inflation.

Senator SARBANES. Was there any thought given to trying to get some or most of the G-7 to cut their interest rates, but not all of them? You know, if the Germans could go along and they didn't go along, but the other nations? And most of the other nations have economies that are, if not in recession, in something of a flat or slowdown mode, do they not?

Mr. MULFORD. That's right. And what I said earlier about engaging in a dialog during a period of changing economic circumstances, I think it's fair to say, Mr. Chairman, that that's a complex discussion, not completed at a single meeting but taking place over a period of time.

The point that we made about interest rates, as I've said, you've seen some changes and we believe that, in coming weeks, we'll see some further changes in countries in Europe of interest rates and further declines.

Senator SARBANES. Was the Fed's move within 2 days after the rebuff at the G-7 to cut the interest rates related to the rebuff?

Mr. MULFORD. You'd have to ask Alan Greenspan that. I just simply can't answer that question.

Senator SARBANES. How worried are you about the prospects for a worldwide economic slowdown?

Mr. MULFORD. I would put it differently.

Senator SARBANES. The Joint Economic Committee, in its report—I don't have it here with me, but there's a table in there

which shows that, in 1973-75, there was a general coincidence worldwide of slowdowns in major economies, which of course then fed the slowdown, making it worse.

In other recessions, economies have tended to move in different directions. So you've had counteracting effects and there's some reason; with a couple of exceptions, we're worried that, in this slowdown, we're getting again a coincidence worldwide of economic slowdown.

How worried are you about that?

Mr. MULFORD. Not particularly worried about that particular problem as you've put it. We have for this year, for example, a projection of 1 percent positive growth aggregate for the G-7 industrial countries. That figure, if you look at the IMF's data, is projected to rise to over 2 percent next year.

The United States has been in recession and it seems to us to be clear that there will be recovery relatively soon. As I said, there can be a dispute over which month that occurs or what the strength of the recovery is. But, as that recovery takes place, of course, the situation will improve.

Meanwhile, in both Germany and Japan, there continues to be relatively strong positive growth. And although that's been weakening, there is a good deal of confidence that those growth levels will continue to be positive in those countries.

Senator SARBANES. This is the chart that I was talking about. This is the 1973-75 period. As you see, this is the United States, Japan, Germany, and Europe except Germany. And you've got the same movement downward, all coinciding in 1973-75. And they're reinforcing the recession.

The concern of course is that you're getting the same kind of movement—not as steep, but the same trend line, in each of those economies with respect to the real GNP growth rates at this time.

And the implications of that.

Mr. MULFORD. The data and the projections don't show that developing trend. But, as I've said to you, we do believe that, among the G-7, there needs to be a greater focus on growth on those policies that will ensure strong growth with price stability.

We think that's a very good stance to be in. And that we should all be focusing on that today because there is uncertainty in the situation.

But we are not in the mode of expecting a deeper and continuing recession that turns into a global recession.

Senator SARBANES. Of course, the IMF has marked down its projection for G-7 growth in 1991, hasn't it? A full point below what they projected last October?

Mr. MULFORD. That's correct. There's been an adjustment downward in the figures by the IMF.

Senator SARBANES. Which supports in a sense the analysis I've just been putting forward, does it not?

Mr. MULFORD. Well, you could argue from your standpoint that it supports the beginning of the analysis but not necessarily the end or the conclusion of it. And we are sensitive, Mr. Chairman, to the problem. That's what we're talking about in the G-7, the need to have attention to policies that produce continuing growth.

Senator SARBANES. When is the next G-7 meeting? In July?

Mr. MULFORD. No. No G-7 Ministerial meeting has been set. The next meeting that brings together the Ministers, though not the Central Bank Governors, would be at the Summit in July. But, the Central Bank Governors do not attend that meeting. It's not a traditionally structured G-7 Ministerial meeting of Ministers and Governors.

Senator SARBANES. What do you expect the economic agenda of the summit in July to be?

Mr. MULFORD. I think this issue we're discussing will certainly be one of the issues. And I think trade and the Uruguay Round and agriculture will also be important issues on the agenda.

Senator SARBANES. The Washington Post, in an editorial on April 30 on the rejection by the G-7 countries of the proposal to cut interest rates said:

The Americans were firmly rebuffed last weekend at the semiannual meeting here of the seven big industrial democracies. The episode is an illustration of the great melancholy truth that power lies with creditors, not with debtors. And over the past 10 years, the United States has borrowed its way from being the world's greatest creditor to precisely the opposite.

What's your view of that assessment?

Mr. MULFORD. My view, first of all, on the opening part of that is that it is highly inaccurate. In other words, we didn't just attend the meeting and propose that everybody should cut interest rates.

What we did was have the dialog that I tried to run through a few minutes ago and indicate the importance of the focus of our policies, because the G-7 now needs to reassemble a consensus which reflects better the present underlying economic trends in the various countries. And that was the subject for discussion.

Among the issues was the question of high real interest rates and, of course, high real interest rates do discourage growth. And the highest real interest rates today are in Europe. And that is of concern to us because that's been an important growth area.

We made those points. The fact that there was in this case a rather emotional response I think is not really reflective of the kind of dialog that's taken place. Since the meeting, as I pointed out, there have been actions by a number of countries in the interest rate field.

So, clearly, the dialog is one that's going to move along. It will have to take account of what happens in terms of data. But we think that this is an issue on which we had a good hearing.

But I don't think it's correct to say that we simply made a proposal and were rebuffed.

Also, I think it's highly inaccurate, as I've seen in some other press accounts, to portray that the President made the same proposal to the visiting Ministers. That's simply not true.

Senator SARBANES. What about the other part of the statement:

The great melancholy truth that power lies with creditors, not with debtors, and that over the past 10 years, the United States has borrowed its way from being the world's greatest creditor to precisely the opposite?

Mr. MULFORD. I think that statement is, again, rather superficial. It is clear that to have a heavily indebted position is not necessarily a great advantage. But, the United States has not had difficulty in financing its deficit. We've had no difficulty attracting foreign funds. Indeed, in recent months, we've seen a sharp decline of

short-term interest rates and a reasonably substantial decline in long-term rates, until just recently, when they've turned up again a bit.

But, they're still well below where they were 6 months to a year ago. So that would suggest that the prognosis in that article, although in a theoretical sense having relevance, is not really applicable to the present circumstances of the United States.

Senator SARBANES. Mr. Secretary, I'm going to close now and we're going to go in a moment to Fred Bergsten. But, I want to refer back to the title in the trade bill that we passed, as you will recall, after considerable negotiations back and forth between the Congress and the administration.

I think there's a general view that this title on exchange rates and international economic policy coordination, I think, has worked in a way that has, by and large, met the best hopes for it, not the worst fears for it.

In it, we require that, when you're looking at manipulation, that you look at countries that have material global current account surpluses, and have significant bilateral trade surpluses with the United States.

The question I want to put to you is whether you couldn't have a situation in which a country did not have both of those things, but was manipulating the currency with the United States in such an egregious way as to have a significant bilateral trade surplus with us, even though it might not have a material global current account surplus.

If that's the case, it ought to be a matter of concern to us because, as far as our bilateral relationship is concerned, it's being abused, even though the country has not moved into a positive, overall international global current account surplus.

What's your view of that?

Mr. MULFORD. I think that is possible.

Senator SARBANES. Is Korea doing that, do you think? You cite in your report that they moved into a modest global deficit last year, as a reason for not manipulating its currency.

Mr. MULFORD. Yes.

Senator SARBANES. You also say in your report, quote:

The exchange rate also continues to be influenced by pervasive foreign exchange rate controls in Korea. These forces control the forces of supply and demand in the exchange market. Historic trade and investment flows have positioned the authorities to manipulate the exchange rate through indirect means.

Of course, you also make reference in your report to:

The continuing fundamental denials of national treatment for foreign financial institutions in Korea.

I wonder if you could just expand on that.

Mr. MULFORD. Yes. I think the summary you've made, which I won't repeat because it is in the report, is intended to convey a sense of concern about Korea's approach. It's true they've gone into deficit. They're going to be in deficit this year.

But, it's also true that they are pursuing policies aimed once again at pumping up their exports. It's true that they have a paraphernalia of restrictions and policies and a lack of transparency

often that seems to conspire to produce the results that you suggested.

We remain concerned about that and are following it very carefully. When you add to that the kind of restrictive and unfair policies that Korea follows in the financial area, then we become very, very concerned. And I personally would say that, among the various countries we deal with, we have had the least level of cooperation consistently from Korea of all countries that we've worked with.

We are in the middle of financial negotiations with them. They haven't gone very well; they're not producing good results. I'm concerned about that.

I'm also concerned about this overall problem that you've put your finger on, which would suggest that Korea is really in a way seeking to escape being labeled as a manipulator on the exchange rate front while it still obtains as much of the same advantages it can get through other means.

And I think we've got to be alive to that and ready to jump on that if we possibly can.

Senator SARBANES. Thank you very much. I think maybe the subcommittee will have to give some thought. We need to look as to whether we should have maybe hearings that are more country focused. I mean, we get your general report and, of course, a good part of the hearing is spent on various countries.

But, we also have to address the general issues that are contained within the report, as we've done here today. But, if we continue to see instances in which these efforts aren't producing a response, we may have to start developing a more careful record with respect to specific countries.

It's not my particular desire to necessarily place that kind of spotlight. But, if we're not getting anywhere in the course of your dealings and if it's a subsection of each succeeding report, we may have to raise it to a somewhat higher level.

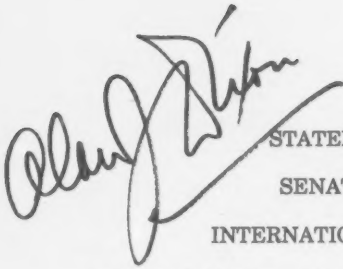
The committee will have to give some thought to that.

Mr. MULFORD. I'm certainly ready to come up at any time to testify and work with the committee, and so is the staff of the Treasury, Mr. Chairman.

Senator SARBANES. Thank you very much. We appreciate your report.

[Witness excused.]

[Prepared statement of Senator Dixon follows:]



MAY 16, 1991

STATEMENT OF SENATOR ALAN J. DIXON
SENATE BANKING SUBCOMMITTEE ON
INTERNATIONAL FINANCE AND MONETARY POLICY
HEARING ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY

MR. CHAIRMAN, I AM PLEASED TO BE HERE THIS AFTERNOON AT THIS HEARING OF THE SENATE BANKING SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY. I WELCOME UNDER SECRETARY OF THE TREASURY DAVID MULFORD BACK BEFORE THE SENATE BANKING COMMITTEE, AND I LOOK FORWARD TO HIS TESTIMONY AND TO THE TREASURY DEPARTMENT'S REPORT TO CONGRESS ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY.

I WOULD LIKE TO EXPRESS MY CONCERN WITH THE RISE OF THE DOLLAR RELATIVE TO OTHER INTERNATIONAL CURRENCIES IN FEBRUARY AND MARCH OF THIS YEAR. THE DOLLAR HAS REMAINED AT THOSE HIGHER LEVELS DURING THE PAST TWO MONTHS. OBVIOUSLY, THIS DISADVANTAGES U.S. EXPORTS, AND IT LIMITS OUR ABILITY TO OVERCOME THE CURRENT RECESSION.

ADDITIONALLY, AT THE G-7 MEETING IN WASHINGTON SEVERAL WEEKS AGO, THE ASSEMBLED MINISTERS AND GOVERNORS FAILED TO TAKE ANY ACTION TO LOWER INTEREST RATES. THIS ALSO LIMITS GROWTH INTERNATIONALLY AND DOMESTICALLY -- AND CAUSES ME CONCERN.

I LOOK FORWARD TO SECRETARY MULFORD'S VIEW OF THIS SITUATION. THANK YOU, MR. CHAIRMAN.

Senator SARBANES. The committee will take just a very short recess. Then we will resume and hear from Fred Bergsten, a former Assistant Secretary of the Treasury, Assistant Secretary for International Affairs of the Treasury. And now the Director of the Institute for International Economics.

We'll resume in just a couple of moments. [Recess.]

The committee will resume.

We're very pleased to have Fred Bergsten, presently Director of the Institute for International Economics, and formerly Assistant Secretary of the Treasury for International Affairs with us to discuss the G-7 meeting and current international economic and exchange rate policy.

Fred, we're very pleased to have you with us. We'd be happy to hear from you.

STATEMENT OF C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

Mr. BERGSTEN. Mr. Chairman, thank you very much for inviting me, particularly because I think it's very important that this committee hold hearings now on this topic, given some recent developments.

I also think it's very important for this committee to have as a regular practice the holding of hearings on these twice-a-year Treasury reports on the exchange rate and U.S. international economic policy.

As I recall the Trade Act of 1988, a chapter was put in to try to increase the transparency of U.S. policy in this area. The hearings of this committee in pursuit of that objective are extremely important and something you should do as a regular matter. I'm delighted you're doing it.

I take the view at this point that the main prospect for U.S. economic recovery now lies on the trade side. We have had a very large trade improvement recently, and that has at least kept the recession from being a lot worse. If we don't have the prospect for continued trade improvement in the future, I think the prospects for recovery from the recession are not very good. In that vein, the fact that the exchange rate of the dollar has gone up so much of late, I'm afraid, undermines the prospect for continued trade improvement. Therefore, in addition to perpetuating the large trade deficit that we know has been a problem for many years, an overly strong dollar at this time adds to the risk of the whole economy failing to recover, at least in any kind of satisfactory way.

The other point is that this hearing comes right on the heels of a G-7 meeting that I think reveals the greatest disarray in the group since at least Black Monday of 1987. That's worrisome because it means that, at any time, those disagreements could break out into the open and adversely affect markets as well as underlying economic conditions.

Let me quickly tick off my analysis of the current situation and then respond to any questions you might have.

First, I would praise the G-7 and the U.S. Treasury because only 3 months ago the U.S. dollar was falling to all-time record lows. There were fears that, with the Fed reducing interest rates and the

Germans raising interest rates, the dollar could literally collapse and cause lots of difficulty.

At that point, the G-7 forged an effective consensus to halt the dollar's slide. The members intervened in a coordinated, effective manner and began to actively talk up the dollar. The strategy worked and the dollar's slide was stopped. The G-7 simultaneously achieved a stable international financial market and left the dollar at a level that was highly competitive for American industry, thereby reinforcing our trade position and the outlook for continued trade contribution to economic recovery.

The problem, however, is that the G-7 were unable to replicate that success on the flip side. When the dollar then began to rise, partly because they had been so successful at stopping its decline, the G-7 were unable to respond in any effective way to keep the dollar from rising so significantly that it began to undermine our competitive position.

From early February until just a week or two ago, the dollar rose by more than 20 percent against the European currencies, particularly the deutschmark, more than 10 percent against the Japanese yen, and about 10 percent overall. One key number to keep in mind is that every percentage point rise in the value of the dollar adversely affects our current account balance by somewhere between \$6 and \$10 billion over the succeeding couple of years. So, any deterioration in our competitiveness due to a higher dollar inexorably hurts our trade position, hurts our economy, and, at a time like this when we need export-led growth, hurts the whole prospect for recovery.

The G-7's failure to react to the rise in the dollar reveals the asymmetry in the underlying G-7 situation now. They were able to come to an agreement to stop the dollar's slide back in February because they happened to agree at that point on an ad hoc response. But they have no system in place.

Four or five years ago, they had the so-called reference ranges or target zones, which provided not only a floor under the dollar but a ceiling as well. This time the G-7 were able to place a floor under it, but they didn't even try to put a ceiling on its rise. The fact that our own Government apparently made no effort to do that strikes me as quite worrisome and, in fact, inconsistent with the congressional mandate in the Trade Act of 1988, which calls on our Government to try to maintain a competitive exchange rate for the dollar.

I worry not only about that 10-percent rise in the dollar, which could hurt our external position by \$60 to \$100 billion over a couple of years, but the fact that if there is no effective effort to stop the dollar from rising, it could start rising again at any time. In fact, in the markets there's a widespread expectation that the dollar could again resume its upward climb, and that neither the G-7 nor the U.S. Government would express any difficulty with that.

If that happened, our trade competitiveness would be hurt even more. I can't say I'm overwhelmingly alarmed by the current level of the dollar, although I'm much less comfortable with it than where it was 3 months ago. But if it were to rise another 10 per-

cent and keep on going up, which could easily happen, then the issue really would begin to become quite serious.

Senator SARBANES. Let me interject right there with a question.

Secretary Mulford indicated that he thought that, at the current levels, the United States was competitive in international markets. He was then pressed on how much of a change would have to take place for him to depart from that statement.

And he refused to answer that question. I mean, he treated it as hypothetical, which it was, but he treated it as a hypothetical that he didn't want to answer.

He was then asked, "Well, are we close to the edge in that regard?" And he stuck to his hypothetical response.

What's your view of those questions?

Mr. BERGSTEN. I answer the question by noting that, despite the big improvement in the U.S. trade position in the last few years, we are still running a current account deficit of about \$100 billion. That is occurring despite a recession, which of course dampens the demand for imports, and so, on a full-employment basis, the external deficit would have to be regarded as even higher.

That, of course, means we have to keep borrowing \$8 to \$10 billion a month from the rest of the world, building our foreign debt position and the like. So I would submit that we clearly need a lot of further improvement that's needed, simply in terms of traditional concerns about the trade balance and its financing.

I'm adding now the dimension that, without continued trade improvement, I think our whole economic outlook is for continued sluggish growth at best, maybe not even coming out of the recession any time very soon.

So I worry about any significant deterioration in our competitive position. It would be hard, I think, for anybody to deny that a rise of 10 percent in the value of the dollar, as has occurred in the last few months, does not hurt our competitive position. So I would reject that premise, and I would submit that any further increase in the dollar's value from that level would be very much against the national interest.

At my Institute, we have done a series of studies to try to assess an equilibrium value for the dollar. There is some disagreement among us within the Institute. Some, like myself, are hawkish and think that we should try to totally eliminate the current account deficit. Some of my colleagues think that if we can get it down to \$50 billion, which is less than 1 percent of current GNP, that's good enough.

But even my less hawkish colleagues, when they do their calculations, see an equilibrium exchange rate for the dollar as something like 1.50 marks and 110-120 yen, not the levels where we are now.

Senator SARBANES. Just for the record, why don't you give us the levels where we are right now?

Mr. BERGSTEN. We are right now at about 1.70 marks to the dollar, as contrasted with the rate of 1.50 marks or even less that I and my colleagues calculate would be needed for equilibrium in that exchange rate relationship.

The yen-dollar rate is now at about 140 to 1 between 135 and 140. Our calculations suggest that something between 110 and 120 would be required even to bring our external deficit down to \$50

billion on a lasting basis. If we wanted to totally eliminate our external deficit, my own calculations suggest that a yen-dollar rate of something like 100 to 1 would be called for.

Senator SARBANES. What was the rate when the G-7 forged the consensus to halt the dollar's slide at that point, as you say here?

Mr. BERGSTEN. At that time, the focus was on the dollar DM rate. They seemed to be defending it, at one point, at 1.45 DM to the dollar, which I think was an appropriate level.

I applauded that move both in terms of its effect on market stability and the level that they seemed to be targeting at that time. The yen rate at that time was not so much a focus. There was not as much market movement. But the yen did appreciate to about 125, which is considerably closer to an equilibrium level than where we are today.

Senator SARBANES. Why don't you go on?

Mr. BERGSTEN. The only other thing I wanted to say, Mr. Chairman, was that I think these trade issues, which have been critical for many years because of their effect on our need to borrow money, on our becoming a debtor country, and the like, are really now of overwhelming importance for the whole economy.

I think the current recession is much deeper than most people recognize. Without the huge improvement that we've had in trade over the last couple of quarters, the recession would have almost been twice as great as it has been, and deeper than the 1982 recession. In fact, it would have been the deepest since the 1930's.

Moreover, I'm afraid that, because of the excesses of the 1980's, we don't have any policy tools now to promote domestic demand in the economy. The budget deficit is obviously too large to permit fiscal stimulus. And although I applaud the reductions in interest rates, I'm afraid that monetary policy now has relatively little impact because of the fragility of the financial system—manifested in the credit crunch. Banks simply aren't lending, even with money rates lower. Long-term interest rates, in fact, have not come down very much. Bank spreads have increased as banks try to strengthen their financial positions. I think the Federal Reserve is essentially pushing on a string, so that neither fiscal nor monetary policy is very effective in stimulating domestic demand and resuming growth in the economy.

Therefore, particularly given the deep recession I think we're starting from, further trade improvement is absolutely essential to provide any hope for an early and substantial recovery. And I note that the Congress, in fact, anticipated that kind of development in the Trade Act of 1988 when it required the administration—and I have pulled some quotes out of the act—"to achieve exchange rates consistent with more appropriate balances in trade"—that is, better than a \$100 billion deficit—"in conjunction with economic growth," which we don't have.

I do want to applaud the Treasury on one more account but also put a criticism in that context. At the recent G-7 meeting, I think the Treasury was right to push most of the other countries to reduce their interest rates to stimulate growth because we do have a threat of a world recession. Most of Europe is now either in recession or headed toward it. Growth in Asia is still positive, but it's trending down quite substantially. There is a significant world

slowdown. Therefore, I think the Treasury is right to push the other countries to try to stimulate their economies through lower interest rates, because real interest rates are very high.

But I think they made a big mistake to push Germany, partly because Germany wasn't going to do it, and does face an overheating problem. In addition, if the other six members of the G-7 had reduced their interest rates while Germany did not, the result would have been to strengthen the deutschmark against the dollar in the exchange markets. That would have pulled the rest of the European currencies up against the dollar too because they're tied to the DM in the European Monetary System. That, through the way cross rates work, would also have pulled the yen up against the dollar. So you would simultaneously have had most of the countries stimulating growth and demand for our exports, but also bringing the dollar exchange rate back down and improving our price competitiveness.

So I would recommend that the Treasury continue its effort to stimulate world growth but do so through pushing for a G-6 interest rate cut, consciously letting the Germans keep their rates higher. One could look for that to correct the exchange rate movements that we've had over the past months and thereby, from a U.S. standpoint, strengthen both our price competitiveness and the world markets into which we can sell.

[The complete prepared statement of C. Fred Bergsten follows:]

G-7 DISARRAY AND THE DOLLAR:
THE NEED FOR A NEW US STRATEGY

Statement by

C. Fred Bergsten
Director
Institute for International Economics

Before the

Subcommittee on International Finance and Monetary Policy

Committee on Banking, Housing and Urban Affairs
United States Senate

May 16, 1991

Today's hearing is especially important for three reasons:

- o Further substantial improvements in the US trade balance are critical for recovery of our economy from the current recession.
- o The recent large increase in the exchange rate of the dollar undermines the prospect for such improvement and runs counter to the requirements of the Omnibus Trade and Competitiveness Act of 1988 that the United States maintain a competitive exchange rate.
- o The total failure of the latest meeting of the Group of Seven (G-7), which is clearly in its greatest disarray since before Black Monday in 1987.

G-7 Success: Stabilizing the Dollar in Early 1991

I would start, however, by praising the successful effort of the US Government and G-7 in stopping the fall of the dollar that occurred earlier this year. Due to the desynchronization of the world economy, the United States reduced interest rates in February to fight its recession while Germany raised interest rates to cope with potential overheating. As a result, the dollar plunged to record lows and there were renewed fears of a "free fall" that would intensify our own inflation and could have panicked the markets.

Fortunately, the G-7 forged an effective consensus to halt the dollar slide at that point. The member countries intervened in a coordinated manner and began to actively "talk up the dollar." The strategy worked and the dollar slide was stopped at a level which left the United States quite competitive in world

trade--at about 1.45-1.50 DM (with rates at similar levels for the other EMS currencies) and about 125W.

Much of the press misinterpreted this episode, suggesting that "international coordination had failed" because the United States and foreign economies were moving in different directions. This was quite wrong: the goal of G-7 coordination is primarily to avoid negative international effects of differences in underlying economic patterns, which they clearly did. Moreover, it was highly fortunate for the United States that the world economy had become desynchronized (for the first time since the 1960s): our recession was blunted by continued growth abroad that enabled us to keep expanding our exports.

G-7 Failure: The Present Problem

The efforts of the US Government and G-7 in this area, however, have gone steady downhill since that successful operation in February. Having stopped the decline of the dollar, they subsequently let it soar--by more than 20 percent against the DM and other European currencies, about 10 percent against the yen and about 10 percent overall. Each rise of one percentage point in the trade-weighted exchange rate of the dollar leads to a deterioration of at least \$6-7 billion in the US current account position over the succeeding two years.

Indeed, the G-7 action was partially responsible for the renewed rise of the dollar. Its successful intervention in February convinced the traders they could not make money by selling dollars. Hence they turned to buying dollars, pushing the rate up in a self-reinforcing pattern because "the trend is your friend."

The United States and G-7 failed to react to the rise in the dollar and hence the markets kept pushing it up. The G-7 was apparently unable to reach any consensus on stopping the new trend. Of even greater concern here, the US Government apparently made no effort to resist the move and implied that the stronger dollar was fully acceptable. The underlying problem is that the G-7 has apparently abandoned the "reference ranges" they had adopted in 1987, which would have provided a ceiling as well as floor for the dollar against the DM and yen, and are relegated to ad hoc responses on those all too rare occasions when a consensus emerges.

This recent rise of 10 percent in the dollar could, if not reversed, produce a deterioration of \$60-70 billion--more than one percent of GNP--in our external balance from where we were earlier this year. The situation could become much worse if the dollar were to resume its upward movement in the near future, which is quite possible absent any counter effort by the United States and G-7. There has in fact been extensive discussion in

the markets that the dollar could rise by at least another 10 percent in the foreseeable future.

The Impact on the US Economy

These developments are crucial to the outlook for the American economy. The current recession is much deeper than usually recognized: without the huge improvement in our trade balance over the past two quarters, the recession would have been almost twice as great--deeper than in 1982 and indeed the worst in the postwar period. Moreover, we have no policy tools to expand domestic demand: the budget deficit is obviously too large to permit fiscal stimulus and monetary policy has little impact because of the fragility of our financial system. Further improvements in our trade position are thus essential to provide any hope of early and substantial recovery.

The renewed strength of the dollar therefore undermines our economic outlook at a crucial time. Moreover, as noted, it ignores the requirement of the Trade Act of 1988 "to achieve...exchange rates consistent with more appropriate...balances in trade...in conjunction with economic growth."

There is of course a second requirement for America to achieve export-led growth--continued expansion of our foreign markets. Moreover, growth in all of those countries is slowing down and there is a real threat of a substantial slowdown in world growth--even a world recession. The Treasury has therefore been correct to push for new expansionary policies in the major foreign countries and it should continue to do so.

However, as noted, the Treasury needs to push simultaneously for a correction of the recent exchange rate movements. At the recent meetings, it therefore should have promoted interest rate reductions by the G-6--all of the major countries excluding Germany. This is partly because it was clear that Germany was not prepared to ease monetary policy. In addition, interest rate cuts by the G-6 would have led to a strengthening of the DM in the exchange markets. This would in turn have pulled up the other European currencies against the dollar, since they are linked to the DM through the EMS, and the yen as well through cross-rate movements throughout the markets. Such a strategy could have produced, and could still produce, a combination of faster foreign growth and dollar correction.

Instead, the result from the recent meetings was a sharp clash between the United States and Germany--with several of the other key countries sympathetic to the latter. The disarray was reminiscent of that which occurred before, and was partly responsible for, Black Monday in 1987.

More importantly, the clash reveals a fundamental substantive difference within the G-7. There is clearly no consensus about the risk of a sharp world slowdown or recession, which is acute. Moreover, there seems to be no effort--and no US push--to avoid the risk of a renewed dollar climb or to reverse the rise that has recently occurred. At a crucial moment in the world economy, the G-7 is in considerable disarray.

It is thus urgent for the US Government to adopt a new and more effective strategy to push simultaneously for these two objectives, leading up to the London summit in July. My own suggestion, as noted, is for a renewed round of coordinated interest rate cuts by the G-6--all members of the group excluding Germany. This would lead simultaneously to faster growth abroad and a currency correction. Such steps in turn would help both to avert world recession and promote continued improvement in our own trade position, thereby enhancing our prospects for early and more substantial recovery. I hope that these hearings will help produce such a strategy.

Senator SARBANES. How serious do you think the possibility of a worldwide downturn is?

Mr. BERGSTEN. If we mean a result of actually negative growth for the world as a whole, I think that outcome is not too likely because there continues to be enough economic expansion in Asia. But if you look at huge parts of the world, for example the whole Anglo-Saxon world—the United States, Canada, Australia, New Zealand—they're already in recession and clearly not yet coming out of it. Big parts of Europe, including Britain, are already in recession. Literally every European country outside of Germany is down to 1 percent growth, like in France, or less, and is risking recession. Latin America is still in the doldrums, though there is some pickup in Mexico. Most parts of the world are either in or threatened by recession.

Statistically, continued growth in Asia might keep the world in the positive column but it could be 1 percent growth or less. Even the IMF's growth forecast for this year is only 1.3 percent, and I think that will turn out to be overly optimistic because it assumes a pretty sharp U.S. recovery in the second half.

The IMF forecast for next year is for some modest pickup, to around 2 percent, but I simply don't see where that's likely to come from. So I think a very sluggish world economy with a lot of it in flat or negative terrain is a quite plausible outcome.

Senator SARBANES. Now one of the things we provided for in the title were reports on countries that were manipulating their currency in order to gain a trade advantage.

Do you have any observations about what's taking place in that arena?

Mr. BERGSTEN. I do, but I'll preface it with one remark. Frankly, I think the language, as it emerged finally in the act about manipulating exchange rates, was a bit misplaced. I think we should worry not so much about manipulation, but about results, that is, where the exchange rates lie. For example, the G-7 is manipulating exchange rates all the time. When it intervened to stop the dollar's slide back in February, it was manipulating the exchange rates. When the United States intervenes to defend or weaken the dollar, it's manipulating the exchange rate.

I don't think the issue is whether governments should have an active exchange rate policy. I think they should. It's whether they are aiming for levels of exchange rates that are compatible with world economic interests—their own interests, in the U.S. case.

Senator SARBANES. What the statute said is where countries manipulate the rate of exchange between their currency and the U.S. dollar for purposes of preventing effective balance of payments adjustments, or gaining unfair competitive advantage in international trade.

Mr. BERGSTEN. Right. Defined that way, it's a good objective and sometimes the rest of that is forgotten. That's the problem.

On that criterion, the focus has been the Asian NIC's. I was recently in Korea, which is now running a current account deficit. I predicted that when I testified before one of the other committees here in the Senate 2 years ago. Korea, after having run big surpluses for 3 years, has had an enormous adjustment, partly because the Koreans did let their currency rise sharply in value.

They're now again in deficit. In fact, in the first part of this year, they were even running a bilateral deficit on trade with the United States. So I think one has to say that Korea is now back on track.

I think Taiwan is still a problem because Taiwan, though its surplus has come down a long way, is still running a very large surplus both in absolute terms and as a share of its GNP. Our analysis has suggested that a stronger exchange rate for its currency is called for as part of the adjustment of that country. And I think that's still the case.

I gather that, in the new Treasury report, there is the conclusion that the People's Republic of China is also now manipulating its exchange rates.

Senator SARBANES. We spent a lot of time here this afternoon on the People's Republic of China.

Mr. BERGSTEN. I have not yet read what the Treasury says on that, and I have not given it the same attention as I have the other countries. I know that the Chinese exchange rate system has been extremely complex, and extremely easy to manipulate for these purposes. So I would have some sympathy for the Treasury's view. But I don't want to give you a considered judgment until I take a close look at what the Treasury has said and study the question.

Senator SARBANES. Do you really think that export growth can be enough to pull us out of the recession, or to give us any sort of movement, even if we come out of the recession?

Mr. BERGSTEN. I do not think that export growth can be enough by itself to pull us out of the recession. But I have to admit that even I have been amazed at how much it has helped to dampen the recession.

Let me just elaborate the numbers I mentioned cryptically in my remarks. In the absence of the trade improvement in volume terms the last two quarters, we would have had a turndown in the fourth quarter of last year at an annual rate of 5.6 percent of GNP, and in the first quarter of this year of 3.8 percent. Averaging the two, we would have had a negative GNP performance at an annual rate of about 5 percent over the last 2 quarters.

Yet the trade improvement was so great that those downturns were only minus 1.8 percent and minus 2.6 percent, respectively, for an average of about 2 percent instead of almost 5 percent. So the trade improvements that we have already seen these last two quarters, as included in the GNP, enormously cut the rate of recession.

What I have projected is that, over the next few years, we could get one percentage point a year of positive improvement. I don't say it's going to be more than that but that could be the marginal difference in a sluggishly growing economy.

Senator SARBANES. I'm interested in your assertion earlier that fiscal policy has been totally immobilized. I mean, that's true. But, should it be true?

Mr. BERGSTEN. I'm afraid that, with the budget deficit at the level that it is now, any significant fiscal stimulus that increased the numbers further might backfire simply by spooking the bond and other financial markets, triggering fears of a pickup in inflation down the road and, therefore, higher long-term interest rates.

I think we've let ourselves get into a position, with the huge budget deficits of the 1980's, along with the continued inflation pressures underlying the economy despite the recession, in which it is very difficult for us to contemplate any significant fiscal stimulus.

Senator SARBANES. What about at least a response with respect to the unemployment insurance system, which, in a sense, may be more humanitarian than a fiscal stimulus?

Would you explain to me any economic rationale for building up the surplus in the extended benefit trust fund of the unemployment insurance system, in a recession?

I mean, that trust fund had a \$7.2 billion balance at the end of the last fiscal year. I had always thought that we built the surplus up in order to draw it down in a recession. Not only are we not drawing that surplus down, we, in fact, right now, are building it up even further.

The trust fund is taking in more money—significantly more money this year—in the range of about \$1 billion is estimated—than it's going to pay out.

What's the rationale for that in the midst of a recession?

Mr. BERGSTEN. I see no rationale for that either. And I agree with you that highly targeted humanitarian fiscal measures are possible. The budget costs of what you were just suggesting are not great and would not have the kind of effect on the markets I was talking about.

I was really addressing the traditional kind of fiscal stimulus package—\$50 billion or more in expansionary measures. Even with our budget deficits at current levels, those numbers would look big, would increase the deficit by a substantial amount, and, I'm afraid, could backfire.

Simply to underline, I think we are now paying the price for the errors of the 1980's, with the big budget deficits immobilizing fiscal policy and the fragility of the financial system going a long way to immobilize monetary policy.

We've gotten into this bind now, I fear, without any very positive tools to get out of it. Targeted measures that don't have huge fiscal costs are surely feasible. And I think the case you make for drawing down the unemployment insurance fund is an extremely good one.

Senator SARBANES. What outlook do you all have for the economy?

Mr. BERGSTEN. Sluggish, slow recovery at best. Traditionally, the United States has had V-shaped recessions: short, sharp downward fall and then an equally sharp, abrupt recovery. This time, I think, the pattern has been and will tend to be very different.

From the first quarter of 1989 forward, we never had a quarter where the annual growth rate exceeded 1.7 percent. We had almost 2 years of very sluggish growth before we dropped into the recession. It was a U-shape instead of a V on the downside. I think it's going to be the same on the upside.

I think there will be a recovery in the sense that we'll get out of negative terrain sometime toward the end of this year or early next. But, when we do, the recovery will be very modest.

I think the forecasters who are projecting the usual sharp and short recovery are extrapolating really from past recessions, which we did not enter with the structural problems that we have now, namely, the big budget deficit and, therefore, the immobility of fiscal policy, and particularly the fragility of the financial system, which means you don't have the liquidity and financial lubricant being applied to the system that you normally do in a recovery period.

So I think, at best, it's going to be slow and sluggish.

Senator SARBANES. Let me ask you one more question.

The Post, in an editorial at the end of April, said when we were rebuffed at the G-7 meeting on trying to get the interest rates cut, and I quote them:

The episode is an illustration of the great melancholy truth that power lies with creditors, not with debtors. And over the past 10 years, the United States has borrowed its way from being the world's greatest creditor to precisely the opposite.

Now, you said that some of your colleagues at the Institute envision running, if they wanted to get the trade deficit down, from \$100 billion to \$50 billion, but then they thought it could run along at \$50 billion. Of course, each year it does that only deepens our debtor position.

What's the rationale that can, in effect, warrant or justify continuing in such a trade deficit position and, therefore, a worsening debtor posture internationally?

Mr. BERGSTEN. As I said, my own preference is to stop the debt buildup. In fact, I prefer even more the proposal you put forward about 4 years ago that we should go back to running surpluses and actually reduce the debt.

But the rationale for my colleagues' position is the following:

At an external deficit level of, say, \$50 billion or 1 percent of GNP a year, the ratio of our foreign debt to our GNP or to our exports would stabilize now or in the near future. The debt would not be rising any faster than our economy would be rising, or even than our foreign exchange earnings through exports would be rising. And that ratio of debt to GNP or debt to exports would still be well outside the traditional danger zones that Third World countries and others have found cause difficulty when they got to that level.

Senator SARBANES. It seems to me small comfort to say that the United States, supposedly the world's leading power, is running at levels which have not yet projected them into the danger zone for Third World countries. I mean, that's not much of a standard of economic performance, is it?

Mr. BERGSTEN. I agree. Furthermore, I would add that, when you run the world's key currency, as the dollar still is despite all our vicissitudes, you may be particularly vulnerable. You've got a huge stock of foreign holdings of your currency.

If those debt ratios at some point reached a level, which might be even far short of the danger points for Third World countries, where confidence was lost, you could see such a huge run on the bank that even the United States would suffer very large costs.

I'd like to add one other point in addition to the one you cite about how power shifts from the debtors to the creditors. Another

thing that fascinated me about this recent G-7 episode was how there seemed to be zero spillover from the Gulf War. This G-7 meeting was held less than 2 months after the United States led the coalition that wiped out Saddam Hussein militarily and was heralded as the restoration of American leadership. Indeed, it did so in military terms but it has not spilled over into the economic arena.

I mention that point because a number of observers at the time that the Gulf War was completed were heralding it as some kind of renaissance of U.S. power, arguing that it might carry over into lots of other issue areas.

We sure haven't seen it here. We have not yet seen it in any breakthrough in the Uruguay Round or in any other economic issue I'm aware of. That says not only that power has shifted from debtors to creditors, but that the determining elements in world power have moved much more to the economic domain.

Even when you pull off a stunning military success, it doesn't seem to buy you anything elsewhere. I think that's another important lesson, which again responds to those who would have us cop out on the economics by hoping that something else will bail us out.

I think this is the latest evidence that we still have to pull up our socks and get our house in order.

Senator SARBANES. Thank you very much. It's been very helpful testimony and we appreciate it.

The committee now stands adjourned.

[Whereupon, at 4:10 p.m., the committee was adjourned.]

[Response to written questions follows:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM
DAVID MULFORD



ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON

July 3, 1991

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Enclosed are responses to the questions you submitted to Under Secretary Mulford following his testimony before the Senate Banking, Housing, and Urban Affairs Committee on May 16, 1991.

Please do not hesitate to contact me if I may be of further assistance.

Sincerely,

Mary C. Sophos

Mary C. Sophos
Acting Assistant Secretary
(Legislative Affairs)

Enclosure

Q.1. You state on page 4 of your testimony that the principal cause of China's external surpluses, including its \$10.4 billion trade surplus with the United States, is its pervasive administrative control over external trade and payments. Does the Administration plan to press China to end such practices as part of its price for supporting continued MFN trade status for China? If not, why not?

A.1. The Administration does not plan to make extension of MFN for China contingent upon improvement in China's trade and payments policies.

The Administration has launched comprehensive market access negotiations with China. The negotiations will cover the range of China's administrative trade controls. Our objective is to fundamentally improve access to China's market on a non-discriminatory basis, which will in turn improve prospects for increased U.S. exports to China.

To link the market access negotiations to extension of MFN would be counterproductive and risk derailment of the ongoing constructive dialogue on trade issues.

Q2: You state on page 4 of your written testimony that Taiwan continues to run an \$11.2 billion surplus in its trade with the United States. Do you think that country's exchange and capital restrictions contribute to its trade surplus with the United States? If so, what measures is the United States going to take to deal with that problem?

A2: Taiwan's exchange and capital controls have been significantly liberalized since Treasury initiated bilateral discussions in 1987. With the revision of the foreign exchange system in April 1989 and subsequent measures since then, all foreign exchange transactions in Taiwan can now be freely determined. There is no evidence the Central Bank has recently been intervening in the market to "manipulate" the rate and gain competitive advantage.

Capital controls have been substantially eased since 1987. Annual limits remain on non-trade related capital inflows and outflows of \$3 million each per entity, but may have little practical effect. Over the last 3 years, for example, outward remittances averaged only \$26,000, with just 4 cases out of 10,000 exceeding \$3 million. Even so, we believe the limits should continue to be relaxed and the Central Bank has indicated its intention to do so.

Taiwan has taken a number of other steps to liberalize its foreign exchange system and capital controls over the past year and since the October 1990 report to Congress. We have addressed these measures in some detail in our May 1991 report.

Given such liberalization, it is unlikely that Taiwan's current exchange and capital controls play a central role in its trade surplus with the United States. Nonetheless, the restrictions do impede the full operation of market forces in exchange rate determination. We will, thus, continue to encourage Taiwan to relax such restrictions fully in order to foster a more rapid decline in its external surpluses.

Q. 3: I am very concerned over our continued trade deficit with Japan. If we continue to lower our own interest rates to get out of the recession, and if Japan refuses to lower its interest rates, will that strengthen the dollar against the yen and further enlarge our trade deficit with that country?

A. 3: Both the overall U.S. trade deficit, and the bilateral deficit with Japan, have declined substantially from their peaks in 1987. The overall deficit is down by about 1/3; that vis-a-vis Japan alone by over 25 percent. The same factors are at work -- robust growth in Japan and other markets abroad; the substantial decline in the dollar against the yen and other major currencies from its peaks in early 1987, aided by the Plaza Agreement in September 1987; and, more recently, the U.S. recession.

Interest rates have several influences on the prospects for continued reduction in the U.S. trade deficit, essentially through their impact on growth and the exchange rate.

- Lower U.S. interest rates, and higher interest rates in Japan and other major countries, will tend to encourage domestic demand growth in the United States and discourage it in countries whose rates remain high. In turn, this will tend to encourage U.S. imports and discourage U.S. exports, making reduction in our trade deficit more difficult.
- Higher Japanese interest rates will tend to cause the yen to strengthen, not weaken, vis-a-vis the dollar. Other things equal, a stronger yen will discourage Japanese exports, and encourage Japanese imports. However, on average vis-a-vis the other major currencies, the dollar has shown no long-term tendency in either direction since it hit its lows in 1987. Over the last 3 or more years, it has fluctuated within plus or minus 10 percent around its 1987 levels. Similarly, the yen has fluctuated without any apparent trend -- it is currently in the range of 1/\$, compared with a high of 120 and a low of 160 since 1987.

On balance, we believe the growth effect, accompanied by continued progress in market opening by Japan, is the more important aspect of Japanese interest rate policy for sustained reduction of trade imbalances.